STATE OF CALIFORNIA
Franchise Tax Board

Summary of Federal Income Tax Changes 2017

Laws Affected

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

Summary of Federal Income Tax Changes 2017

Prepared by the Staff of the

Franchise Tax Board

STATE OF CALIFORNIA

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EXECUTIVE SUMMARY

Prepared by the Staff of the
Franchise Tax Board (FTB)
State of California

During 2017, the Internal Revenue Code (IRC) or its application by California was changed by:

PUBLIC LAW	TITLE	DATE
115-63	Disaster Tax Relief and Airport and Airway Extension Act of 2017	October 6, 2017
115-97	An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018 (Tax Cuts and Jobs Act)	December 22, 2017

This report explains the new 2017 federal laws along with the effective dates, the corresponding California law, if any, including an explanation of any changes made in response to the new federal law, and the impact on California revenue if California were to conform to applicable federal changes.

This report also contains citations to the section numbers of federal Public Laws, the IRC, and the California Revenue and Taxation Code (R&TC) impacted by the federal changes.

This report contains the following exhibits:

Exhibit A	*2017 Miscellaneous Federal Acts Impacting the IRC Not Requiring a California Response* - Short explanations of federal law changes that are either not administered by the FTB or are not applicable to California.
Exhibit B	*Expiring Tax Provisions* - A complete listing of expiring provisions in California tax law.
Exhibit C	*Revenue Tables* - The impact on California revenue were California to conform to the federal changes.

TITLE V—TAX RELIEF FOR HURRICANES HARVEY, IRMA, AND MARIA

Section	Section Title
501	Definitions

Background

Present law provides a variety of tax relief provisions for victims of the hurricanes that hit the Gulf region in 2005.[1] These provisions include suspending certain limitations on deductions for personal casualty losses;[2] extending the replacement period for nonrecognition of gain,[3] providing an employee retention credit for affected employers; allowing additional first-year depreciation for certain property; increasing the amount that may be expensed;[4] allowing certain demolition and clean-up costs to be expensed; altering the carryback period for net operating losses that result from public utility property disaster losses; extending the carryback period for net operating losses; liberalizing the representation requirements for owners of residential real property financed by private activity bonds; providing tax beneficial rules for distributions to disaster victims from qualified retirement plans; and, allowing certain retirement plan amendments made in light of the disaster to be retroactive.

New Federal Law (Uncodified Act section 501)

The uncodified provision defines a net disaster loss as the excess of qualified disaster-related personal casualty losses over personal casualty gains. Qualified disaster-related personal casualty losses are losses which arise:

- In the Hurricane Harvey disaster area on or after August 23, 2017, and which are attributable to Hurricane Harvey;
- In the Hurricane Irma disaster area on or after September 4, 2017, and which are attributable to Hurricane Irma; or
- In the Hurricane Maria disaster area on or after September 16, 2017, and which are attributable to Hurricane Maria.

A disaster “zone” means the portion of the disaster area determined by the President to warrant individual or individual and public assistance from the federal government under the

[1] Public Law 109-73, Katrina Emergency Tax Relief Act of 2005 (KETRA), and Public Law 109-35, Gulf Opportunity Zone Act of 2005 (GO Zone Act). IRC sections 1400O, 1400P, 1400Q, 1400R, 1400S and 1400T.
[2] IRC section 165.
[3] IRC section 1033.
[4] IRC section 179.

Robert T. Stafford Disaster Relief and Emergency Assistance Act[5] by reason of the disaster. A disaster "area" means an area with respect to which a major disaster has been declared by the President by reason of the disaster.

Effective Dates

This provision is effective upon enactment (September 29, 2017) for losses arising in the Hurricane Harvey disaster area on or after August 23, 2017, the Hurricane Irma disaster area on or after September 4, 2017, and Hurricane Maria disaster area on or after September 16, 2017.

California Law (None)

California does not conform to the uncodified federal act provisions.

Impact on California Revenue

Not applicable.

Section	Section Title
502	Special Disaster-Related Rules for Use of Retirement Funds

Background

A loan from a qualified employer plan to a participant or beneficiary is treated as a plan distribution unless, among other things: (1) the loan amount doesn't exceed the lesser of $50,000, or half of the present value of the employee's nonforfeitable accrued benefit under the plan (however, a loan up to $10,000 is allowed, even if it exceeds half the employee's accrued benefit);[6] and (2) the loan is required to be repaid within five years,[7] except that a longer repayment period can be used for a principal residence plan loan.[8]

Early withdrawals, generally pre-age 59 ½, from a qualified retirement plan result in regular taxable income plus an additional tax applies equal to 10 percent of the amounts withdrawn that are includible in gross income.[9] The additional tax applies unless the taxpayer qualifies for one of several specific exceptions.[10]

[5] Public Law 100-707.
[6] IRC section 72(p)(2)(A).
[7] IRC section 72(p)(2)(B)(i).
[8] IRC section 72(p)(2)(B)(ii).
[9] IRC section 72(t)(1).
[10] IRC sections 72(t)(2) and 72(t)(3).

New Federal Law (Uncodified Act section 503 affecting IRC sections 72, 402, 408, and 3405)

This provision eases a number of rules to allow victims to make qualified hurricane distributions (QHD) from their retirement plans of up to $100,000, less any prior withdrawals treated as QHDs. It also excepts QHDs from the 10-percent additional tax for early withdrawals and allows taxpayers to spread out any income inclusion resulting from such withdrawals over a 3-year period, beginning with the year that any amount is required to be included.

A QHD is defined as any distribution from an eligible retirement plan,[11] including individual retirement accounts (IRAs), made:

- On or after August 23, 2017, and before January 1, 2019, to an individual whose principal place of abode on August 23, 2017, is located in the Hurricane Harvey disaster area and who has sustained an economic loss by reason of Hurricane Harvey;
- On or after September 4, 2017, and before January 1, 2019, to an individual whose principal place of abode on September 4, 2017, is located in the Hurricane Irma disaster area and who has sustained an economic loss by reason of Hurricane Irma; and
- On or after September 16, 2017, and before January 1, 2019, to an individual whose principal place of abode on September 16, 2017, is located in the Hurricane Maria disaster area and who has sustained an economic loss by reason of Hurricane Maria.

The provision also allows the amount distributed to be re-contributed at any time over a 3-year period beginning on the day after the distribution was received. If the amount is re-contributed to an eligible retirement plan other than an IRA, the taxpayer is treated as having received the QHD in an eligible rollover distribution[12] and as having transferred the amount to an eligible retirement plan in a direct, trustee-to-trustee transfer within 60 days of the distribution. If the amount is re-contributed to an IRA, the QHD is treated as a distribution[13] that is transferred to an eligible retirement plan in a direct trustee to trustee distribution within 60 days of the distribution.

QHDs aren't treated as eligible rollover distributions for purposes of the 20-percent withholding requirement.[14]

The provision also allows for the re-contribution of certain retirement plan withdrawals for home purchases or construction, which were received after February 28, 2017, and before September 21, 2017, where the home purchase or construction was cancelled on account of Hurricanes Harvey, Irma, or Maria. A timely re-contribution avoids tax on the plan withdrawal if made during the period beginning on August 23, 2017, and ending on February 28, 2018.

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[11] IRC section 402(c)(8)(B).
[12] IRC section 402(c)(4).
[13] IRC section 408(d)(3).
[14] IRC section 3405(c)(1)(B).

With respect to retirement plan loans, the provision:

- Increases the maximum amount that a participant or beneficiary can borrow from a qualified employer plan,[15] from $50,000 to $100,000,
- Removes the one half of present value limitation, and
- Allows for a longer repayment term, if the due date for any repayment with respect to the loan occurs during a qualified beginning date that is Hurricane-specific and ends on December 31, 2018, by delaying the due date of the first repayment by one year and adjusting the due dates of subsequent repayments accordingly.

Effective Date

This provision is effective as of the date of enactment, September 29, 2017.

California Law (R&TC sections 17024.5, 17081, 17085, 17085.7, and 17501)

Except for the federal changes applicable to retirement plan loans, California automatically conforms to the federal changes with respect to QHDs from and re-contributions to a hurricane victim's retirement plan[16]. Under the Personal Income Tax Law (PITL), California generally conforms to retirement plan loan rules as of the "specified date" of January 1, 2015,[17] and as a result, does not conform to the modifications made by this loan provision.

California withholding on eligible rollover distributions is 10 percent of the federal withholding amount.[18] However, because under this provision the federal 20-percent withholding is not applicable to QHDs that are eligible rollover distributions, California withholding does not apply.

California also automatically conforms to any federal changes made to the additional tax on early distributions from qualified retirement plans, modified to provide that the California early-distribution tax is 2.5 percent of the amount includible in income rather than the federal rate of 10 percent.

Impact on California Revenue

Baseline.

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[15] IRC section 72(p)(2)(A).
[16] Under R&TC section 17501, California conforms by reference to Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, including Part I (IRC sections 401 to 420, relating to pension, profit-sharing, stock bonus plans, etc.), as of R&TC section 17024.5's "specified date" of January 1, 2015. However, except for increases in the maximum amount of elective deferrals that may be excluded from income under IRC section 402(g), R&TC section 17501(b) specifically provides that federal changes to Part I of Subchapter D of Chapter 1 of Subtitle A of the IRC automatically apply without regard to taxable year to the same extent as applicable for federal income tax purposes (and thus California adopts all changes made to those IRC sections without regard to the "specified date" contained in R&TC section 17024.5).
[17] R&TC section 17081 conforms to IRC section 72(p), relating to loans treated as distributions, as of the "specified date" of January 1, 2015, contained in R&TC section 17024.5.
[18] Unemployment Insurance Code (UIC) section 13028(c)(3).

Section	Section Title
503	Disaster-Related Employment Relief

Background

The general business credit (GBC) is a limited nonrefundable credit against income tax that is claimed after all other nonrefundable credits. The GBC includes many credits, including the investment credit, work opportunity credit, alcohol fuels credit, enhanced oil recovery credit, renewable electricity production credit, and marginal oil and gas well production credit. A GBC is allowed against income tax for a particular taxable year and equals the sum of GBC carryforwards to the taxable year, the current year GBC, and GBC carrybacks to the taxable year.[19]

New Federal Law (Uncodified Act section 503 affecting IRC sections 38 and 51)

The provision creates a new "employee retention credit" for eligible employers affected by Hurricanes Harvey, Irma, and Maria. Eligible employers are generally defined as employers that conducted an active trade or business in a disaster zone as of the specified dates of August 23, 2017, for Hurricane Harvey, September 4, 2017, for Hurricane Irma, and September 16, 2017, for Hurricane Maria, and the active trade or business was, on any day between the specified date and January 1, 2018, rendered inoperable as a result of damage sustained by the hurricane.

In general, the credit is treated as a GBC, and is equal to 40 percent of up to $6,000 of qualified wages with respect to each eligible employee of such employer for the taxable year.

Qualified wages means wages[20] paid or incurred by an eligible employer with respect to an eligible employee on any day after the specified date and before January 1, 2018, that occurs during the period beginning on the date on which the employer's trade or business first became inoperable at the principal place of employment of the employee immediately before the respective hurricane, and ending on the date on which such trade or business has resumed significant operations at such principal place of employment.

Qualified wages includes wages paid without regard to whether the employee performs no services, performs services at a different place of employment than the principal place of employment, or performs services at the principal place of employment before significant operations have resumed. An employee cannot be taken into account more than one time for purposes of the employee retention tax credit. So, for example, if an employee is an eligible employee of an employer with respect to Hurricane Harvey for purposes of the credit, the employee cannot also be an eligible employee of the employer with respect to Hurricane Irma or Hurricane Maria.

[19] IRC section 38(a). Also, IRC section 38(b) contains a list of the component credits of the current year business credit.
[20] As defined in IRC section 51(c)(1) but without regard to IRC section 3306(b)(2)(B).

The provision also provides that rules[21] similar to those disallowing the work opportunity tax credit (WOTC) when the employee is considered related to the employer, and rules similar to those that apportion the WOTC among commonly-controlled businesses, shall apply.[22]

Effective Date

The provision is effective for wages paid or incurred after August 23, 2017, for Hurricane Harvey, September 4, 2017, for Hurricane Irma, and September 16, 2017, for Hurricane Maria through January 1, 2018.

California Law (None)

California does not conform to the new federal employee retention credit or to existing federal GBC provisions.

Impact on California Revenue

Not applicable.

Section	Section Title
504	Additional Disaster-Related Tax Relief Provisions

Background

Charitable Contribution Deduction

An individual who itemizes can deduct charitable contributions up to 50 percent, 30 percent, or 20 percent of adjusted gross income (AGI), depending on the type of property contributed and the type of donee.[23] A corporation generally can deduct charitable contributions up to 10 percent of its taxable income.[24] Amounts that exceed the ceilings, referred to as excess contributions, can be carried forward for five years by both individuals and corporations, subject to various limitations and ordering rules.[25] For individuals, charitable contributions are deductible only as an itemized deduction.[26]

[21] IRC section 51(i)(1).
[22] IRC section 52.
[23] IRC section 170(b)(1).
[24] IRC section 170(b)(2).
[25] IRC section 170(d).
[26] Treasury Regulation section 1.170A-1(a).

Casualty Losses

Under present law, a taxpayer may generally claim a deduction for any loss sustained during the taxable year and not compensated by insurance or otherwise.[27] For individual taxpayers, deductible losses must be incurred in a trade or business or other profit-seeking activity or consist of property losses arising from fire, storm, shipwreck, or other casualty, or from theft. Personal casualty or theft losses for the taxable year are allowable only if the loss exceeds $100 per casualty or theft.[28] In addition, aggregate net casualty and theft losses are deductible only to the extent they exceed 10 percent of an individual taxpayer's AGI.[29] If the disaster occurs in a presidentially-declared disaster area, the taxpayer may elect to take into account the casualty loss in the taxable year immediately preceding the taxable year in which the disaster occurs.[30]

Earned Income Tax Credit (EITC) and Child Tax Credit (CTC)

An eligible individual is allowed an EITC equal to the credit percentage of earned income (up to an "earned income amount") for the tax year.[31] For 2017, the earned income amount is $6,670 for taxpayers with no qualifying children, $10,000 for those with one qualifying child, and $14,040 for those with two or more qualifying children.

For purposes of the EITC, earned income includes wages, salaries, tips, and other employee compensation, but only if those amounts are includible in gross income for the taxable year; plus net earnings from self-employment less the deduction for half of self-employment tax[32] for the year.[33]

Individuals can claim a $1,000 CTC for each qualifying child the taxpayer can claim as a dependent.[34] The child must be under 17 and a U.S. citizen or resident alien.[35] The amount of the allowable credit is reduced (not below zero) by $50 for each $1,000 (or fraction thereof) of modified AGI (AGI increased by excluded foreign, possession, and Puerto Rico income) above: $110,000 for joint filers, $75,000 for unmarried individuals, and $55,000 for married taxpayers filing separately.[36] To the extent the CTC exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit equal to 15 percent of earned income in excess of a threshold dollar amount.[37]

[27] IRC section 165.
[28] IRC section 165(h)(1).
[29] IRC section 165(h)(2).
[30] IRC section 165(i).
[31] IRC section 32.
[32] IRC section 164(f).
[33] IRC section 32(c)(2)(A).
[34] IRC section 24.
[35] IRC section 24(c).
[36] IRC section 24(b).
[37] IRC section 24(d).

New Federal Law (Uncodified Act section 504 affecting IRC sections 24, 32, 56, 63, 68, 165, 170, 509, 4966, and 6213)

Temporary Suspension of Limitations on Charitable Contributions

For qualifying charitable contributions associated with qualified hurricane relief, the provision:

- Temporarily suspends the majority of the AGI limitations on charitable contributions,
- Provides that such contributions will not be taken into account for purposes of applying AGI and carryover period limitations to other contributions,
- Provides eased rules governing the treatment of excess contributions, and
- Provides an exception from the overall limitation on itemized deductions for certain qualified contributions.

Qualified contributions must be paid during the period beginning on August 23, 2017, and ending on December 31, 2017, in cash to an organization to which individual contributions are limited to 50 percent of AGI (determined without regard to any net operating loss carryback),[38] for relief efforts in the Hurricanes Harvey, Irma, or Maria disaster areas. Qualified contributions must also be substantiated, with a contemporaneous written acknowledgement that the contribution was or is to be used for relief efforts, and the taxpayer must make an election to apply these provisions. For partnerships and S corporations, the election is made separately by each partner or shareholder.

Casualty Losses

For taxpayers claiming a net disaster loss, the provision eliminates the current law requirement that personal casualty losses must exceed 10 percent of AGI to qualify for a deduction. The provision also eliminates the current law requirement that taxpayers must itemize deductions to access this tax relief for losses by increasing an individual taxpayer's standard deduction by the net disaster loss.

The law which generally disallows the standard deduction for alternative minimum tax purposes, does not apply for the portion of the standard deduction attributable to the net disaster loss. In addition, the provision increases the $100 per-casualty floor to $500 for qualified disaster-related personal casualty losses.

Special Rule for Determining Earned Income for the EITC and CTC

The provision stipulates that, in the case of a qualified individual, if the earned income of the taxpayer for the taxable year which includes the applicable date is less than the taxpayer's earned income for the preceding tax year, then the taxpayer may, for purposes of the EITC and CTC, substitute the earned income for the preceding year for the earned income for the taxable year that includes the applicable date. If the election is made, it applies for purposes of both the refundable EITC and CTC.

[38] IRC section 170(b)(1)(A).

For Hurricane Harvey, a qualified individual is one whose principal place of abode on August 23, 2017, was located either in the Hurricane Harvey disaster zone, or in the Hurricane Harvey disaster area, and the individual was displaced from their principal place of abode by reason of Hurricane Harvey. Similar definitions apply for Hurricane Irma using a September 4, 2017, date and Hurricane Maria using a September 16, 2017, date. In the case of joint filers, the above election may apply if either spouse is a qualified individual.

Effective Date

The provision is effective for charitable contributions made during the period August 23, 2017, through December 31, 2017, for casualty losses arising on August 23, 2017, for Hurricane Harvey, September 4, 2017, for Hurricane Irma, and September 16, 2017, for Hurricane Maria; and for determining earned income for taxable years beginning after December 31, 2016.

California Law (R&TC sections 17052, 17062, 17072, 17073.5, 17077, 17201, 17207, 17276, 24347, 24347.5, 24357 – 24357.9, and 24416)

Temporary Suspension of Limitations on Charitable Contributions

Under the PITL, California generally conforms to the federal charitable contribution rules under IRC section 170 as of the "specified date" of January 1, 2015,[39] and as a result, does not conform to the hurricane relief suspension of AGI limitations, exclusion of carryover period limitations to other contributions, eased rules governing the treatment of excess contributions, and exception from the overall limitation on itemized deductions.

Under the CTL, California does not conform to IRC section 170, but instead has stand-alone law that is generally similar to federal law allowing corporations a deduction for charitable contributions.[40] There are no similar provisions for hurricane relief suspension of AGI limitations, exclusion of carryover period limitations to other contributions, and eased rules governing the treatment of excess contributions.

Casualty Losses

California conforms by reference to IRC section 165, relating to losses, as of the "specified date" of January 1, 2015.[41] Thus, under California law personal casualty or theft losses are deductible for individual taxpayers to the extent they exceed $100 per casualty or theft, and aggregate net casualty and theft losses are deductible only to the extent they exceed 10 percent of an individual taxpayer's AGI.

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[39] R&TC section 17201 conforms to IRC section 170, relating to charitable, etc., contributions and gifts, as of the "specified date" of January 1, 2015, with modifications in R&TC sections 17206, 17275.2, 17275.3, and 17275.5.
[40] R&TC sections 24357 – 24359.1.
[41] R&TC section 17024.5.

California does not conform to the federal standard deduction amounts, but instead has its own standard-deduction provision.[42] Thus, the standard deduction is unaffected by qualified disaster-related personal casualty losses.

Special Rule for Determining Earned Income for the EITC and CTC

For each taxable year beginning on or after January 1, 2015, California's PITL conforms to the federal EITC as in effect under federal law for that taxable year, with modifications. The definition of earned income is modified to include wages, salaries, tips, and other employee compensation, but only if such amounts are subject to California withholding.[43] Additionally, net earnings from self-employment is included in the definition of earned income for taxable years beginning on or after January 1, 2017.[44]

Thus, California does not conform to the provision to substitute the earned income for the preceding year for the earned income for the taxable year that includes the applicable dates during which individuals were displaced from their principal place of abode in hurricane zones and areas.

Impact on California Revenue

Not applicable.

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[42] R&TC section 17073.5.
[43] Pursuant to Division 6 (commencing with section 13000) of the Unemployment Insurance Code.
[44] SB 106 (Committee on Budget and Fiscal Review, Chapter 96, Statutes of 2017).

TITLE I, Subtitle A—Individual Tax Reform

Part I—Tax Rate Reform

Section	Section Title
11001	Modification of Rates

Background

In General

To determine regular tax liability, an individual taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her regular taxable income. The rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer's income increases.

Tax Rate Schedules

Separate rate schedules apply based on an individual's filing status. For 2017, the regular individual income tax rate schedules are as follows:

FEDERAL INDIVIDUAL INCOME TAX RATES FOR 2017[45]

If taxable income is:	Then income tax equals:
Single Individuals	
Not over $9,325	10% of the taxable income
Over $9,325 but not over $37,950	$932.50 plus 15% of the excess over $9,325
Over $37,950 but not over $91,900	$5,226.25 plus 25% of the excess over $37,950
Over $91,900 but not over $191,650	$18,713.75 plus 28% of the excess over $91,900
Over $191,650 but not over $416,700	$46,643.75 plus 33% of the excess over $191,650
Over $416,700 but not over $418,400	$120,910.25 plus 35% of the excess over $416,700
Over $418,400	$121,505.25 plus 39.6% of the excess over $418,400
Heads of Households	
Not over $13,350	10% of the taxable income
Over $13,350 but not over $50,800	$1,335 plus 15% of the excess over $13,350
Over $50,800 but not over $131,200	$6,952.50 plus 25% of the excess over $50,800
Over $131,200 but not over $212,500	$27,052.50 plus 28% of the excess over $131,200
Over $212,500 but not over $416,700	$49,816.50 plus 33% of the excess over $212,500
Over $416,700 but not over $444,550	$117,202.50 plus 35% of the excess over $416,700
Over $444,550	$126,950 plus 39.6% of the excess over $444,550

[45] Revenue Procedure 2016–55, 2016–45 I.R.B. 707, section 3.01.

Married Individuals Filing Joint Returns and Surviving Spouses

Not over $18,650 ....10% of the taxable income
Over $18,650 but not over $75,900 ....$1,865 plus 15% of the excess over $18,650
Over $75,900 but not over $153,100 ....$10,452.50 plus 25% of the excess over $75,900
Over $153,100 but not over $233,350 ....$29,752.50 plus 28% of the excess over $153,100
Over $233,350 but not over $416,700 ....$52,222.50 plus 33% of the excess over $233,350
Over $416,700 but not over $470,700 ....$112,728 plus 35% of the excess over $416,700
Over $470,700 ....$131,628 plus 39.6% of the excess over $470,700

Married Individuals Filing Separate Returns

Not over $9,325 ....10% of the taxable income
Over $9,325 but not over $37,950 ....$932.50 plus 15% of the excess over $9,325
Over $37,950 but not over $76,550 ....$5,226.25 plus 25% of the excess over $37,950
Over $76,550 but not over $116,675 ....$14,876.25 plus 28% of the excess over $76,550
Over $116,675 but not over $208,350 ....$26,111.25 plus 33% of the excess over $116,675
Over $208,350 but not over $235,350 ....$56,364 plus 35% of the excess over $208,350
Over $235,350 ....$65,814 plus 39.6% of the excess over $235,350

Estates and Trusts

Not over $2,550 ....15% of the taxable income
Over $2,550 but not over $6,000 ....$382.50 plus 25% of the excess over $2,550
Over $6,000 but not over $9,150 ....$1,245 plus 28% of the excess over $6,000
Over $9,150 but not over $12,500 ....$2,127 plus 33% of the excess over $9,150
Over $12,500 ....$3,232.50 plus 39.6% of the excess over $12,500

Unearned Income of Children

Special rules (generally referred to as the ''kiddie tax'') apply to the net unearned income of certain children.[46] Generally, the kiddie tax applies to a child if: (1) the child has not reached the age of 19 by the close of the taxable year, or the child is a full-time student under the age of 24, and either of the child's parents is alive at such time; (2) the child's unearned income exceeds $2,100 (for 2017); and (3) the child does not file a joint return.[47] The kiddie tax applies regardless of whether the child may be claimed as a dependent by either or both parents. For children above age 17, the kiddie tax applies only to children whose earned income does not exceed one-half of the amount of their support.

Under these rules, the net unearned income of a child (for 2017, unearned income over $2,100) is taxed at the parents' tax rates if the parents' tax rates are higher than the tax rates of the child.[48] The remainder of a child's taxable income (i.e., earned income, plus unearned income up to $2,100 (for 2017), less the child's standard deduction) is taxed at the child's rates, regardless of whether the kiddie tax applies to the child. For these purposes, unearned income is income other than wages, salaries, professional fees, other amounts received as compensation for

[46] IRC section 1(g).
[47] IRC section 1(g)(2).
[48] Special rules apply for determining which parent's rate applies where a joint return is not filed.

personal services actually rendered, and distributions from qualified disability trusts.[49] In general, a child is eligible to use the preferential tax rates for qualified dividends and capital gains.[50] The kiddie tax is calculated by computing the ''allocable parental tax.'' This involves adding the net unearned income of the child to the parent's income and then applying the parent's tax rate. A child's ''net unearned income'' is the child's unearned income less the sum of (1) the minimum standard deduction allowed to dependents ($1,050 for 2017[51]), and (2) the greater of (a) such minimum standard deduction amount or (b) the amount of allowable itemized deductions that are directly connected with the production of the unearned income.[52]

The allocable parental tax equals the hypothetical increase in tax to the parent that results from adding the child's net unearned income to the parent's taxable income.[53] If the child has net capital gains or qualified dividends, these items are allocated to the parent's hypothetical taxable income according to the ratio of net unearned income to the child's total unearned income. If a parent has more than one child subject to the kiddie tax, the net unearned income of all children is combined, and a single kiddie tax is calculated. Each child is then allocated a proportionate share of the hypothetical increase, based upon the child's net unearned income relative to the aggregate net unearned income of all of the parent's children subject to the tax.

Generally, a child must file a separate return to report his or her income.[54] In such case, items on the parents' return are not affected by the child's income, and the total tax due from the child is the greater of:

The sum of (a) the tax payable by the child on the child's earned income and unearned income up to $2,100 (for 2017), plus (b) the allocable parental tax on the child's unearned income, or

The tax on the child's income without regard to the kiddie tax provisions.[55]

Under certain circumstances, a parent may elect to report a child's unearned income on the parent's return.[56]

Capital Gains Rates

In general

In the case of an individual, estate, or trust, any adjusted net capital gain which otherwise would be taxed at the 10- or 15-percent rate is not taxed. Any adjusted net capital gain which otherwise would be taxed at rates over 15-percent and below 39.6 percent is taxed at a 15-percent rate. Any adjusted net capital gain which otherwise would be taxed at a 39.6-percent rate is taxed at a 20-percent rate.

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[49] IRC section 1(g)(4) and IRC section 911(e)(2).
[50] IRC section 1(h).
[51] Section 3.02 of Revenue Procedure 2016–55, *supra.*
[52] IRC section 1(g)(4).
[53] IRC section 1(g)(3).
[54] IRC section 1(g)(6). See Form 8615, Tax for Certain Children Who Have Unearned Income.
[55] IRC section 1(g)(1).
[56] IRC section 1(g)(7).

The unrecaptured IRC section 1250 gain is taxed at a maximum rate of 25 percent, and 28-percent rate gain is taxed at a maximum rate of 28 percent. Any amount of unrecaptured IRC section 1250 gain or 28-percent rate gain otherwise taxed at a 10- or 15-percent rate is taxed at the otherwise applicable rate.

In addition, a tax is imposed on net investment income in the case of an individual, estate, or trust. In the case of an individual, the tax is 3.8 percent of the lesser of net investment income, which includes gains and dividends, or the excess of modified adjusted gross income over the threshold amount. The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in the case of any other individual.

Definitions

Net Capital Gain

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset, any gain generally is included in income. Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, (5) certain United States (U.S.) publications, (6) certain commodity derivative financial instruments, (7) hedging transactions, and (8) business supplies. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances available under the straight-line method of depreciation.

Adjusted Net Capital Gain

The ''adjusted net capital gain'' of an individual is the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured IRC section 1250 gain. The net capital gain is reduced by the amount of gain that the individual treats as investment income for purposes of determining the investment interest limitation under IRC section 163(d).

Qualified Dividend Income

Adjusted net capital gain is increased by the amount of qualified dividend income.

A dividend is the distribution of property made by a corporation to its shareholders out of its after-tax earnings and profits. Qualified dividends generally includes dividends received from domestic corporations and qualified foreign corporations. The term ''qualified foreign corporation'' includes a foreign corporation that is eligible for the benefits of a comprehensive income tax treaty with the United States which the Treasury Department determines to be satisfactory and which includes an exchange of information program. In addition, a foreign corporation is treated as a qualified foreign corporation for any dividend paid by the corporation with respect to stock that is readily tradable on an established securities market in the United States.

If a shareholder does not hold a share of stock for more than 60 days during the 121-day period beginning 60 days before the ex-dividend date (as measured under IRC section 246(c)), dividends received on the stock are not eligible for the reduced rates. Also, the reduced rates are not available for dividends to the extent that the taxpayer is obligated to make related payments with respect to positions in substantially similar or related property.

Dividends received from a corporation that is a passive foreign investment company (as defined in IRC section 1297) in either the taxable year of the distribution, or the preceding taxable year, are not qualified dividends.

A dividend is treated as investment income for purposes of determining the amount of deductible investment interest only if the taxpayer elects to treat the dividend as not eligible for the reduced rates.

The amount of dividends qualifying for reduced rates that may be paid by a regulated investment company (''RIC'') for any taxable year in which the qualified dividend income received by the RIC is less than 95 percent of its gross income (as specially computed) may not exceed the sum of (1) the qualified dividend income of the RIC for the taxable year and (2) the amount of earnings and profits accumulated in a non-RIC taxable year that were distributed by the RIC during the taxable year.

The amount of qualified dividend income that may be paid by a real estate investment trust (''REIT'') for any taxable year may not exceed the sum of (1) the qualified dividend income of the REIT for the taxable year, (2) an amount equal to the excess of the income subject to the taxes imposed by IRC section 857(b)(1) and the regulations prescribed under IRC section 337(d) for the preceding taxable year over the amount of these taxes for the preceding taxable year, and (3) the amount of earnings and profits accumulated in a non-REIT taxable year that were distributed by the REIT during the taxable year.

Dividends received from an organization that was exempt from tax under IRC section 501 or was a tax-exempt farmers' cooperative in either the taxable year of the distribution or the preceding taxable year; dividends received from a mutual savings bank that received a deduction under IRC section 591; or deductible dividends paid on employer securities are not qualified dividend income.

28-Percent Rate Gain

The term ''28-percent rate gain'' means the excess of the sum of the amount of net gain attributable to long-term capital gains and losses from the sale or exchange of collectibles (as defined in IRC section 408(m) without regard to paragraph (3) thereof) and the amount of gain equal to the additional amount of gain that would be excluded from gross income under IRC section 1202 (relating to certain small business stock) if the percentage limitations of IRC section 1202(a) did not apply, over the sum of the net short-term capital loss for the taxable year and any long-term capital loss carryover to the taxable year.

Unrecaptured Section 1250 Gain

''Unrecaptured IRC section 1250 gain'' means any long-term capital gain from the sale or exchange of IRC section 1250 property (i.e., depreciable real estate) held more than one year to the extent of the gain that would have been treated as ordinary income if IRC section 1250 applied to all depreciation, reduced by the net loss (if any) attributable to the items taken into account in computing 28-percent rate gain. The amount of unrecaptured IRC section 1250 gain (before the reduction for the net loss) attributable to the disposition of property to which IRC section 1231 (relating to certain property used in a trade or business) applies may not exceed the net IRC section 1231 gain for the year.

New Federal Law (IRC 1 and 6695)

Temporary Modification of Rates

The provision temporarily replaces the existing rate structure with a new rate structure.

FEDERAL INDIVIDUAL INCOME TAX RATES FOR 2018 UNDER THE PROVISION

If taxable income is:	Then income tax equals:
Single Individuals	
Not over $9,525	10% of the taxable income
Over $9,525 but not over $38,700	$952.50 plus 12% of the excess over $9,525
Over $38,700 but not over $82,500	$4,453.50 plus 22% of the excess over $38,700
Over $82,500 but not over $157,500	$14,089.50 plus 24% of the excess over $82,500
Over $157,500 but not over $200,000	$32,089.50 plus 32% of the excess over $157,500
Over $200,000 but not over $500,000	$45,689.50 plus 35% of the excess over $200,000
Over $500,000	$150,689.50 plus 37% of the excess over $500,000
Heads of Households	
Not over $13,600	10% of the taxable income
Over $13,600 but not over $51,800	$1,360 plus 12% of the excess over $13,600
Over $51,800 but not over $82,500	$5,944 plus 22% of the excess over $51,800
Over $82,500 but not over $157,500	$12,698 plus 24% of the excess over $82,500
Over $157,500 but not over $200,000	$30,698 plus 32% of the excess over $157,500
Over $200,000 but not over $500,000	$44,298 plus 35% of the excess over $200,000
Over $500,000	$149,298 plus 37% of the excess over $500,000

Married Individuals Filing Joint Returns and Surviving Spouses

Not over $19,050 ....10% of the taxable income
Over $19,050 but not over $77,400 ....$1,905 plus 12% of the excess over $19,050
Over $77,400 but not over $165,000 ....$8,907 plus 22% of the excess over $77,400
Over $165,000 but not over $315,000 ....$28,179 plus 24% of the excess over $165,000
Over $315,000 but not over $400,000 ....$64,179 plus 32% of the excess over $315,000
Over $400,000 but not over $600,000 ....$91,379 plus 35% of the excess over $400,000
Over $600,000 ....$161,379 plus 37% of the excess over $600,000

Married Individuals Filing Separate Returns

Not over $9,525 ....10% of the taxable income
Over $9,525 but not over $38,700 ....$952.50 plus 12% of the excess over $9,525
Over $38,700 but not over $82,500 ....$4,453.50 plus 22% of the excess over $38,700
Over $82,500 but not over $157,500 ....$14,089.50 plus 24% of the excess over $82,500
Over $157,500 but not over $200,000 ....$32,089.50 plus 32% of the excess over $157,500
Over $200,000 but not over $300,000 ....$45,689.50 plus 35% of the excess over $200,000
Over $300,000 ....$80,689.50 plus 37% of the excess over $300,000

Estates and Trusts

Not over $2,550 ....10% of the taxable income
Over $2,550 but not over $9,150 ....$255 plus 24% of the excess over $2,550
Over $9,150 but not over $12,500 ....$1,839 plus 35% of the excess over $9,150
Over $12,500 ....$3,011.50 plus 37% of the excess over $12,500

The provision's rate structure does not apply to taxable years beginning after December 31, 2025.

Unlike present law, which uses a measure of the Consumer Price Index for All Urban Consumers (''CPI–U''), the new inflation adjustment uses the Chained Consumer Price Index for All Urban Consumers (''C–CPI–U'').

Simplification of Tax on Unearned Income of Children

The provision simplifies the "kiddie tax" by effectively applying ordinary and capital gains rates applicable to trusts and estates to the net unearned income of a child. Thus, as under present law, taxable income attributable to earned income is taxed according to an unmarried taxpayers' brackets and rates. Taxable income attributable to net unearned income is taxed according to the brackets applicable to trusts and estates, with respect to both ordinary income and income taxed at preferential rates. Thus, under the provision, the child's tax is unaffected by the tax situation of the child's parent or the unearned income of any siblings.

This provision does not apply to taxable years beginning after December 31, 2025.

Maximum Rates on Capital Gains and Qualified Dividends

The provision generally retains the present-law maximum rates on net capital gain and qualified dividends. The breakpoints between the zero- and 15-percent rates ("15-percent breakpoint") and the 15- and 20-percent rates ("20-percent breakpoint") are based on the same amounts as the breakpoints under present law, except the breakpoints are indexed using the C-CPI-U in taxable years beginning after 2017. Thus, for 2018, the 15-percent breakpoint is $77,200 for joint returns and surviving spouses (one-half of this amount for married taxpayers filing separately), $51,700 for heads of household, $2,600 for estates and trusts, and $38,600 for other unmarried individuals. The 20-percent breakpoint is $479,000 for joint returns and surviving spouses (one-half of this amount for married taxpayers filing separately), $452,400 for heads of household, $12,700 for estates and trusts, and $425,800 for other unmarried individuals.

Therefore, in the case of an individual (including an estate or trust) with adjusted net capital gain, to the extent the gain would not result in taxable income exceeding the 15-percent breakpoint, such gain is not taxed. Any adjusted net capital gain which would result in taxable income exceeding the 15-percent breakpoint but not exceeding the 20-percent breakpoint is taxed at 15 percent. The remaining adjusted net capital gain is taxed at 20 percent.

As under present law, unrecaptured IRC section 1250 gain generally is taxed at a maximum rate of 25 percent, and 28-percent rate gain is taxed at a maximum rate of 28 percent.

Paid Preparer Due Diligence Requirement for Head of Household Status

The provision directs the Secretary of the Treasury to promulgate due diligence requirements for paid preparers in determining eligibility for a taxpayer to file as head of household. A penalty of $500 is imposed for each failure to meet these requirements.

<u>Effective Dates</u>

The provision applies to rates and special rules for children with unearned income for taxable years beginning after December 31, 2017, and before January 1, 2026, and the provision applicable to paid preparers is applicable for taxable years beginning on and after December 31, 2017.

<u>California Law (R&TC sections 17041, 17043, and19167)</u>

Individual Income Tax Rates

California does not conform, under the Personal Income Tax Law (PITL), to federal individual income tax rates, and instead has its own individual income tax rates that range from 1 percent to

12.3 percent.[57] In addition, there is an additional tax of 1 percent on the portion of a taxpayer's taxable income that exceeds $1,000,000.[58] Thus, the maximum personal income tax rate is 13.3 percent.

Tax on Unearned Income of Children

California conforms, under the PITL, to IRC section 1(g), relating to the tax on unearned income of children (kiddie tax), as of the "specified date" of January 1, 2015,[59] with modifications, but does not conform to the federal simplification of the kiddie tax.

Maximum Rates on Capital Gains and Qualified Dividends

California conforms, under the PITL and the CTL, to the federal rules for computing capital gains and losses, as of the specified date of January 1, 2015, with modifications. However, California does not provide special tax rates for net capital gain; instead, such gains are taxed at the same rates as ordinary income.

Paid Preparer Due Diligence Requirement for Head of Household Status

California conforms, under the AFITL, to IRC section 6695(g), related to the penalty for failure to be diligent in determining eligibility for the earned income credit, as of the specified date of January 1, 2015, with a modification to apply the penalty to returns required to be filed on or after June 24, 2015, but does not conform to the new federal penalty for failure to be diligent in determining eligibility for the head of household filing status.

<u>Impact on California Revenue</u>

Individual Income Tax Rates, Maximum Rates on Capital Gains and Qualified Dividends, and Paid Preparer Due Diligence Requirement for Head of Household Status

Not applicable.

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[57] R&TC section 17041. Proposition 30, passed by a majority of California voters on November 6, 2012, added Section 36 to Article XIII of the California Constitution, which temporarily increases the top tax rate of 9.3 percent under R&TC section 17041 for taxable year beginning on or after January 1, 2012, and before January 1, 2019. Proposition 55, passed by a majority of California voters on November 8, 2016, extended the increase for taxable years beginning on or after January 1, 2019, and before January 1, 2031. Under both of these propositions, the 9.3 percent tax rate is increased for taxpayers that have taxable income over $250,000. The increased tax rates are 10.3 percent for the portion of taxable income that is over $250,000 but not over $300,000, 11.3 percent for the portion of taxable income that is over $300,000 but not over $500,000, and 12.3 percent for the portion of taxable income that is over $500,000, recomputed under subdivision (h) of Section 17041 of the R&TC.

[58] R&TC section 17043.

[59] R&TC section 17024.5.

Tax on Unearned Income of Children

Estimated Conformity Revenue Impact of Modification of Rates For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	$300,000,000	$180,000,000	$180,000,000

Section | Section Title
11002 | Inflation Adjustments Based on Chained CPI

Background

Under present law, many parameters of the tax system are adjusted for inflation to protect taxpayers from the effects of rising prices. Most of the adjustments are based on annual changes in the level of the Consumer Price Index for All Urban Consumers (CPI-U).[60] The CPI–U is an index that measures prices paid by typical urban consumers on a broad range of products, and is developed and published by the Department of Labor.

Among the inflation-indexed tax parameters are the following individual income tax amounts: (1) the regular income tax brackets; (2) the basic standard deduction; (3) the additional standard deduction for aged and blind; (4) the personal exemption amount; (5) the thresholds for the overall limitation on itemized deductions and the personal exemption phase-out; (6) the phase-in and phase-out thresholds of the earned income credit; (7) individual retirement account (IRA) contribution limits and deductible amounts; and (8) the saver's credit.

New Federal Law (IRC section 1)

The provision requires the use of the Chained Consumer Price Index for All Urban Consumers (C–CPI–U) to adjust tax parameters currently indexed by the CPI–U. The C–CPI–U, like the CPI–U, is a measure of the average change over time in prices paid by urban consumers. It is developed and published by the Department of Labor, but differs from the CPI–U in accounting for the ability of individuals to alter their consumption patterns in response to relative price changes. The C–CPI–U accomplishes this by allowing for consumer substitution between item categories in the market basket of consumer goods and services that make up the index, while the CPI–U only allows for modest substitution within item categories.

[60] Generally, the IRC adjusts calendar year values for cost of living by using the percentage by which the price index for the preceding calendar year exceeds the price index for a base calendar year. IRC section 1(f).

Under the provision, indexed parameters in the IRC switch from CPI–U indexing to C–CPI–U indexing going forward in taxable years beginning after December 31, 2017. Therefore, in the case of any existing tax parameters that are not reset for 2018, the provision indexes parameters as if CPI–U applies through 2017 and C–CPI–U applies for years thereafter; the provision does not index all existing tax parameters from their base years using the C–CPI–U. Tax parameters with cost-of-living adjustment base years of 2016 and later are indexed solely with C–CPI–U. Therefore, tax values that are reset for 2018 are indexed by the C–CPI–U in taxable years beginning after December 31, 2018.[61] The new federal provision applies the C-CPI-U to both the new temporary and the permanent tax table rates.[62]

Effective Dates

The provision applies to taxable years beginning after December 31, 2017.

California Law (R&TC section 17041(h))

California does not conform, under the PITL, to the federal inflation adjustments, but instead has stand-alone law that recomputes income tax brackets and various other amounts annually based on changes to the California Consumer Price Index.[63]

Impact on California Revenue

Not applicable.

Part II—Deduction for Qualified Business Income

Section	Section Title
11011	Deduction for Qualified Business Income of Pass-Thru Entities

Background

Individual Income Tax Rates

To determine regular tax liability, an individual taxpayer generally must apply the tax rate schedules (or the tax tables) to his or her regular taxable income. The rate schedules are broken into several ranges of income, known as income brackets, and the marginal tax rate increases as a taxpayer's income increases. Separate rate schedules apply based on an individual's filing

[61] One exception is the increased standard deduction which is indexed by C–CPI–U in taxable years beginning after December 31, 2019, and therefore is the same in 2018 and 2019.
[62] IRC section 1(f)(2)(A).
[63] R&TC section 17041(h).

status (i.e., single, head of household, married filing jointly, or married filing separately). For 2017, the regular individual income tax rate schedule provides rates of 10, 15, 25, 28, 33, 35, and 39.6 percent.

Partnerships

Partnerships generally are treated for federal income tax purposes as pass-through entities not subject to tax at the entity level.[64] Items of income (including tax-exempt income), gain, loss, deduction, and credit of the partnership are taken into account by the partners in computing their income tax liability (based on the partnership's method of accounting and regardless of whether the income is distributed to the partners).[65] A partner's deduction for partnership losses is limited to the partner's adjusted basis in its partnership interest.[66] Losses not allowed as a result of that limitation generally are carried forward to the next year. A partner's adjusted basis in the partnership interest generally equals the sum of (1) the partner's capital contributions to the partnership, (2) the partner's distributive share of partnership income, and (3) the partner's share of partnership liabilities, less (1) the partner's distributive share of losses allowed as a deduction and certain nondeductible expenditures, and (2) any partnership distributions to the partner.[67] Partners generally may receive distributions of partnership property without recognition of gain or loss, subject to some exceptions.[68]

Partnerships may allocate items of income, gain, loss, deduction, and credit among the partners, provided the allocations have substantial economic effect.[69] In general, an allocation has substantial economic effect to the extent the partner to which the allocation is made receives the economic benefit or bears the economic burden of such allocation and the allocation substantially affects the dollar amounts to be received by the partners from the partnership independent of tax consequences.[70]

State laws of every state provide for limited liability companies[71] (LLCs), which are neither partnerships nor corporations under applicable State law, but which are generally treated as partnerships for federal tax purposes.[72]

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[64] IRC section 701.
[65] IRC section 702(a).
[66] IRC section 704(d). In addition, passive loss and at-risk limitations limit the extent to which certain types of income can be offset by partnership deductions (sections 469 and 465). These limitations do not apply to corporate partners (except certain closely-held corporations) and may not be important to individual partners who have partner-level passive income from other investments.
[67] IRC section 705.
[68] IRC section 731. Gain or loss may nevertheless be recognized, for example, on the distribution of money or marketable securities, distributions with respect to contributed property, or in the case of disproportionate distributions (which can result in ordinary income).
[69] IRC section 704(b)(2).
[70] Treasury Regulation section 1.704–1(b)(2).
[71] The first LLC statute was enacted in Wyoming in 1977. All States (and the District of Columbia) now have an LLC statute, though the tax treatment of LLCs for State tax purposes may differ.
[72] Under Treasury regulations promulgated in 1996, any domestic nonpublicly traded unincorporated entity with two or more members generally is treated as a partnership for federal income tax purposes, while any single-member domestic unincorporated entity generally is treated as disregarded for Federal income tax purposes (i.e., treated as not separate from its owner). Instead of the applicable default treatment, however, an LLC may elect to be treated as

Under present law, a publicly traded partnership generally is treated as a corporation for federal tax purposes.[73] For this purpose, a publicly traded partnership means any partnership if interests in the partnership are traded on an established securities market or interests in the partnership are readily tradable on a secondary market (or the substantial equivalent thereof).[74]

An exception from corporate treatment is provided for certain publicly traded partnerships, 90 percent or more of whose gross income is qualifying income.[75]

S Corporations

For federal income tax purposes, an S corporation[76] generally is not subject to tax at the corporate level.[77] Items of income (including tax-exempt income), gain, loss, deduction, and credit of the
S corporation are taken into account by the S corporation shareholders in computing their income tax liabilities (based on the S corporation's method of accounting and regardless of whether the income is distributed to the shareholders). A shareholder's deduction for corporate losses is limited to the sum of the shareholder's adjusted basis in its S corporation stock and the indebtedness of the S corporation to such shareholder. Losses not allowed as a result of that limitation generally are carried forward to the next year. A shareholder's adjusted basis in the S corporation stock generally equals the sum of (1) the shareholder's capital contributions to the S corporation and (2) the shareholder's pro rata share of S corporation income, less (1) the shareholder's pro rata share of losses allowed as a deduction and certain nondeductible expenditures, and (2) any S corporation distributions to the shareholder.[78] In general, an

a corporation for Federal income tax purposes. Treasury Regulation section 301.7701–3. These are known as the ''check-the-box'' regulations.

[73] IRC section 7704(a).

[74] IRC section 7704(b).

[75] IRC section 7704(c)(2). Qualifying income is defined to include interest, dividends, and gains from the disposition of a capital asset (or of property described in IRC section 1231(b)) that is held for the production of income that is qualifying income. IRC section 7704(d). Qualifying income also includes rents from real property, gains from the sale or other disposition of real property, and income and gains from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber), industrial source carbon dioxide, or the transportation or storage of certain fuel mixtures, alternative fuel, alcohol fuel, or biodiesel fuel. It also includes income and gains from commodities (not described in IRC section 1221(a)(1)) or futures, options, or forward contracts with respect to such commodities (including foreign currency transactions of a commodity pool) where a principal activity of the partnership is the buying and selling of such commodities, futures, options, or forward contracts. However, the exception for partnerships with qualifying income does not apply to any partnership resembling a mutual fund (i.e., that would be described in section 851(a) if it were a domestic corporation), which includes a corporation registered under the Investment Company Act of 1940 (Public Law Number 76–768 (1940)) as a management company or unit investment trust (IRC section 7704(c)(3)).

[76] An S corporation is so named because its Federal tax treatment is governed by subchapter S of the IRC.

[77] IRC sections 1363 and 1366.

[78] IRC section 1367. If any amount that would reduce the adjusted basis of a shareholder's S corporation stock exceeds the amount that would reduce that basis to zero, the excess is applied to reduce (but not below zero) the shareholder's basis in any indebtedness of the S corporation to the shareholder. If, after a reduction in the basis of such indebtedness, there is an event that would increase the adjusted basis of the shareholder's S corporation stock,

S corporation shareholder is not subject to tax on corporate distributions unless the distributions exceed the shareholder's basis in the stock of the corporation.

Electing S Corporation Status

To be eligible to elect S corporation status, a corporation may not have more than 100 shareholders and may not have more than one class of stock.[79] Only individuals (other than nonresident aliens), certain tax-exempt organizations, and certain trusts and estates are permitted shareholders of an S corporation.

Sole proprietorships

Unlike a C corporation, partnership, or S corporation, a business conducted as a sole proprietorship is not treated as an entity distinct from its owner for federal income tax purposes.[80] Rather, the business owner is taxed directly on business income, and files Schedule C (sole proprietorships generally), Schedule E (rental real estate and royalties), or Schedule F (farms) with his or her individual tax return. Furthermore, transfer of a sole proprietorship is treated as a transfer of each individual asset of the business. Nonetheless, a sole proprietorship is treated as an entity separate from its owner for employment tax purposes,[81] for certain excise taxes,[82] and certain information reporting requirements.[83]

<u>New Federal Law (IRC sections 62, 63, 199A, 6662)</u>

In General

For taxable years beginning after December 31, 2017, and before January 1, 2026, an individual taxpayer generally may deduct 20 percent of qualified business income from a partnership, S corporation, or sole proprietorship, as well as 20 percent of aggregate qualified REIT dividends, qualified cooperative dividends, and qualified publicly traded partnership income. Special rules apply to specified agricultural or horticultural cooperatives. A limitation based on W-2 wages paid and capital is phased in above a threshold amount of taxable income. A disallowance of the deduction with respect to specified service trades or businesses is also phased in above the threshold amount of taxable income.[84]

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such increase is instead first applied to restore the reduction in the basis of the shareholder's indebtedness. IRC section 1367(b)(2).

[79] IRC section 1361. For this purpose, a husband and wife and all members of a family (and their estates) are treated as one shareholder. IRC section 1361(c)(1).

[80] A single-member unincorporated entity is disregarded for Federal income tax purposes, un- less its owner elects to be treated as a C corporation. Treasury Regulation section 301.7701–3(b)(1)(ii). Sole proprietorships often are conducted through legal entities for nontax reasons. While sole proprietorships generally may have no more than one owner, a married couple that files a joint return and jointly owns and operates a business may elect to have that business treated as a sole proprietorship under IRC section 761(f).

[81] Treasury Regulation section 301.7701–2(c)(2)(iv).

[82] Treasury Regulation section 301.7701–2(c)(2)(v).

[83] Treasury Regulation section 301.7701–2(c)(2)(vi).

[84] For purposes of this provision, taxable income is computed without regard to the 20 percent deduction.

Qualified Business Income

Qualified business income is determined for each qualified trade or business of the taxpayer. For any taxable year, qualified business income means the net amount of qualified items of income, gain, deduction, and loss with respect to the qualified trade or business of the taxpayer. The determination of qualified items of income, gain, deduction, and loss takes into account these items only to the extent included or allowed in the determination of taxable income for the year. For example, if in a taxable year, a qualified business has $100,000 of ordinary income from inventory sales, and makes an expenditure of $25,000 that is required to be capitalized and amortized over 5 years under applicable tax rules, the qualified business income is $100,000 minus $5,000 (current-year ordinary amortization deduction), or $95,000. The qualified business income is not reduced by the entire amount of the capital expenditure, only by the amount deductible in determining taxable income for the year.

If the net amount of qualified business income from all qualified trades or businesses during the taxable year is a loss, it is carried forward as a loss from a qualified trade or business in the next taxable year. Similar to a qualified trade or business that has a qualified business loss for the current taxable year, any deduction allowed in a subsequent year is reduced (but not below zero) by 20 percent of any carryover qualified business loss. For example, Taxpayer has qualified business income of $20,000 from qualified business A and a qualified business loss of $50,000 from qualified business B in Year 1. Taxpayer is not permitted a deduction for Year 1 and has a carryover qualified business loss of $30,000 to Year 2. In Year 2, Taxpayer has qualified business income of $20,000 from qualified business A and qualified business income of $50,000 from qualified business B. To determine the deduction for Year 2, Taxpayer reduces the 20 percent deductible amount determined for the qualified business income of $70,000 from qualified businesses A and B by 20 percent of the $30,000 carryover qualified business loss.

Domestic Business

Items are treated as qualified items of income, gain, deduction, and loss only to the extent they are effectively connected with the conduct of a trade or business within the United States.[85] In the case of a taxpayer who is an individual with otherwise qualified business income from sources within the commonwealth of Puerto Rico, if all the income is taxable under IRC section 1 (income tax rates for individuals) for the taxable year, the “United States” is considered to include Puerto Rico for purposes of determining the individual's qualified business income.

Treatment of Investment Income

Qualified items do not include specified investment-related income, deductions, or loss. Specifically, qualified items of income, gain, deduction and loss do not include (1) any item taken into account in determining net long-term capital gain or net long-term capital loss, (2) dividends, income equivalent to a dividend, or payments in lieu of dividends, (3) interest income other than that which is properly allocable to a trade or business, (4) the excess of gain over loss from

[85] For this purpose, IRC section 864(c) is applied by substituting “qualified trade or business (within the meaning of IRC section 199A)” for ‘‘nonresident alien individual or a foreign corporation” or “a foreign corporation.”

commodities transactions, other than those entered into in the normal course of the trade or business or with respect to stock in trade or property held primarily for sale to customers in the ordinary course of the trade or business, property used in the trade or business, or supplies regularly used or consumed in the trade or business, (5) the excess of foreign currency gains over foreign currency losses from IRC section 988 transactions, other than transactions directly related to the business needs of the business activity, (6) net income from notional principal contracts, other than clearly identified hedging transactions that are treated as ordinary (i.e., not treated as capital assets), and (7) any amount received from an annuity that is not used in the trade or business of the business activity. Qualified items under this provision do not include any item of deduction or loss properly allocable to such income.

Reasonable Compensation and Guaranteed Payments

Qualified business income does not include any amount paid by an S corporation that is treated as reasonable compensation of the taxpayer. Similarly, qualified business income does not include any guaranteed payment for services rendered with respect to the trade or business,[86] and to the extent provided in regulations, does not include any amount paid or incurred by a partnership to a partner who is acting other than in his or her capacity as a partner for services.[87]

Qualified Trade or Business

A qualified trade or business means any trade or business other than a specified service trade or business and other than the trade or business of performing services as an employee.

Specified Service Trade or Business

A specified service trade or business means any trade or business involving the performance of services in the fields of health,[88] law, accounting, actuarial science, performing arts,[89]

[86] Described in IRC section 707(c).
[87] Described in IRC section 707(a).
[88] A similar list of service trades or business is provided in IRC section 448(d)(2)(A) and Treasury Regulation section 1.448-1T(e)(4)(i). For purposes of IRC section 448, Treasury regulations provide that the performance of services in the field of health means the provision of medical services by physicians, nurses, dentists, and other similar healthcare professionals. The performance of services in the field of health does not include the provision of services not directly related to a medical field, even though the services may purportedly relate to the health of the service recipient. For example, the performance of services in the field of health does not include the operation of health clubs or health spas that provide physical exercise or conditioning to their customers. See Treasury Regulation section 1.448-1T(e)(4)(ii).
[89] For purposes of the similar list of services in IRC section 448, Treasury regulations provide that the performance of services in the field of the performing arts means the provision of services by actors, actresses, singers, musicians, entertainers, and similar artists in their capacity as such. The performance of services in the field of the performing arts does not include the provision of services by persons who themselves are not performing artists (*e.g.,* persons who may manage or promote such artists, and other persons in a trade or business that relates to the performing arts). Similarly, the performance of services in the field of the performing arts does not include the provision of services by persons who broadcast or otherwise disseminate the performance of such artists to members of the public (*e.g.*, employees of a radio station that broadcasts the performances of musicians and singers). See Treasury Regulation section 1.448-1T(e)(4)(iii).

consulting,[90] athletics, financial services, brokerage services, including investing and investment management, trading, or dealing in securities, partnership interests, or commodities, and any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners. For this purpose, a security and a commodity have the meanings provided in the rules for the mark-to-market accounting method for dealers in securities (IRC sections 475(c)(2) and 475(e)(2), respectively).

Phase-In of Specified Service Business Limitation

The exclusion from the definition of a qualified business for specified service trades or businesses phases in for a taxpayer with taxable income in excess of a threshold amount. The threshold amount is $157,500 (200 percent of that amount, or $315,000, in the case of a joint return) (the "threshold amount"). The threshold amount is indexed for inflation. The exclusion from the definition of a qualified business for specified service trades or businesses is fully phased in for a taxpayer with taxable income in excess of the threshold amount plus $50,000 ($100,000 in the case of a joint return).

For a taxpayer with taxable income within the phase-in range, the exclusion applies as follows: In computing the qualified business income with respect to a specified service trade or business, the taxpayer takes into account only the applicable percentage of qualified items of income, gain, deduction, or loss, and of allocable W-2 wages. The applicable percentage with respect to any taxable year is 100 percent reduced by the percentage equal to the ratio of the excess of the taxable income of the taxpayer over the threshold amount bears to $50,000 ($100,000 in the case of a joint return).

Limitation Based on W-2 Wages and Capital

The provision modifies the wage limit applicable to taxpayers with taxable income above the threshold amount to provide a limit based either on wages paid or on wages paid plus a capital element. Under the provision, the limitation is the greater of (a) 50 percent of the W-2 wages paid with respect to the qualified trade or business, or (b) the sum of 25 percent of the W-2 wages with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property.

For purposes of the provision, qualified property means tangible property of a character subject to depreciation that is held by, and available for use in, the qualified trade or business at the close of the taxable year, and which is used in the production of qualified business income, and for which

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[90] For purposes of the similar list of services in IRC section 448, Treasury regulations provide that the performance of services in the field of consulting means the provision of advice and counsel. The performance of services in the field of consulting does not include the performance of services other than advice and counsel, such as sales or brokerage services, or economically similar services. For purposes of the preceding sentence, the determination of whether a person's services are sales or brokerage services, or economically similar services, shall be based on all the facts and circumstances of that person's business. Such facts and circumstances include, for example, the manner in which the taxpayer is compensated for the services provided (*e.g.,* whether the compensation for the services is contingent upon the consummation of the transaction that the services were intended to effect). See Treasury Regulation section 1.448-1T(e)(4)(iv).

the depreciable period has not ended before the close of the taxable year. The depreciable period with respect to qualified property of a taxpayer means the period beginning on the date the property is first placed in service by the taxpayer and ending on the later of (a) the date 10 years after that date, or (b) the last day of the last full year in the applicable recovery period that would apply to the property under IRC section 168 (without regard to IRC section 168(g)).

For example, a taxpayer (who is subject to the limit) does business as a sole proprietorship conducting a widget-making business. The business buys a widget-making machine for $100,000 and places it in service in 2020. The business has no employees in 2020. The limitation in 2020 is the greater of (a) 50 percent of W-2 wages, or $0, or (b) the sum of 25 percent of W-2 wages ($0) plus 2.5 percent of the unadjusted basis of the machine immediately after its acquisition: $100,000 x .025 = $2,500. The amount of the limitation on the taxpayer's deduction is $2,500.

In the case of property that is sold, for example, the property is no longer available for use in the trade or business and is not taken into account in determining the limitation. The Secretary is required to provide rules for applying the limitation in cases of a short taxable year where the taxpayer acquires, or disposes of, the major portion of a trade or business or the major portion of a separate unit of a trade or business during the year. The Secretary is required to provide guidance applying rules similar to the rules of IRC section 179(d)(2) to address acquisitions of property from a related party, as well as in a sale-leaseback or other transaction as needed to carry out the purposes of the provision and to provide anti-abuse rules, including under the limitation based on W-2 wages and capital. Similarly, the Secretary shall provide guidance prescribing rules for determining the unadjusted basis immediately after acquisition of qualified property acquired in like-kind exchanges or involuntary conversions as needed to carry out the purposes of the provision and to provide anti-abuse rules, including under the limitation based on W-2 wages and capital.

Qualified REIT Dividends, Cooperative Dividends, and Publicly Traded Partnership Income

A deduction is allowed under the provision for 20 percent of the taxpayer's aggregate amount of qualified REIT dividends, qualified cooperative dividends, and qualified publicly traded partnership income for the taxable year. Qualified REIT dividends do not include any portion of a dividend received from a REIT that is a capital gain dividend[91] or a qualified dividend.[92] A qualified cooperative dividend means a patronage dividend,[93] per-unit retain allocation,[94] qualified written notice of allocation,[95] or any similar amount, provided it is includible in gross income and is received from either (1) a tax-exempt benevolent life insurance association, mutual ditch or irrigation company, cooperative telephone company, like cooperative organization,[96] or a taxable or tax-exempt cooperative that is described in IRC section 1381(a), or (2) a taxable cooperative governed by tax rules applicable to cooperatives before the enactment of subchapter T of the IRC in 1962. Qualified publicly traded partnership income means (with respect to any qualified trade

[91] Defined in IRC section 857(b)(3).
[92] Defined in IRC section 1(h)(11).
[93] Defined in IRC section 1388(a).
[94] Defined in IRC section 1388(f).
[95] Defined in IRC section 1388(c).
[96] Described in IRC section 501(c)(12).

or business of the taxpayer) the sum of the (a) net amount of the taxpayer's allocable share of each qualified item of income, gain, deduction, and loss (that are effectively connected with a U.S. trade or business and are included or allowed in determining taxable income for the taxable year and do not constitute excepted enumerated investment-type income, and not including the taxpayer's reasonable compensation, guaranteed payments for services, or (to the extent provided in regulations) IRC section 707(a) payments for services) from a publicly traded partnership not treated as a corporation, and (b) gain recognized by the taxpayer on disposition of its interest in the partnership that is treated as ordinary income (for example, by reason of IRC section 751).

Determination of the Taxpayer's Deduction

The taxpayer's deduction for qualified business income for the taxable year is equal to the sum of (a) the lesser of the combined qualified business income amount for the taxable year or an amount equal to 20 percent of the excess of taxpayer's taxable income over any net capital gain[97] and qualified cooperative dividends, plus (b) the lesser of 20 percent of qualified cooperative dividends and taxable income (reduced by net capital gain). This sum may not exceed the taxpayer's taxable income for the taxable year (reduced by net capital gain). Under the provision, the 20-percent deduction with respect to qualified cooperative dividends is limited to taxable income (reduced by net capital gain) for the year. The combined qualified business income amount for the taxable year is the sum of the deductible amounts determined for each qualified trade or business carried on by the taxpayer and 20 percent of the taxpayer's qualified REIT dividends and qualified publicly traded partnership income. The deductible amount for each qualified trade or business is the lesser of (a) 20 percent of the taxpayer's qualified business income with respect to the trade or business, or (b) the greater of 50 percent of the W-2 wages with respect to the trade or business or the sum of 25 percent of the W-2 wages with respect to the trade or business and 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property.

Deduction Against Taxable Income

The provision clarifies that the 20-percent deduction is not allowed in computing adjusted gross income, and instead is allowed as a deduction reducing taxable income. Thus, for example, the provision does not affect limitations based on adjusted gross income. Similarly the provision clarifies that the deduction is available to both non-itemizers and itemizers.

Treatment of Agricultural and Horticultural Cooperatives

For taxable years beginning after December 31, 2017, but not after December 31, 2025, a deduction is allowed to any specified agricultural or horticultural cooperative equal to the lesser of (a) 20 percent of the cooperative's taxable income for the taxable year or (b) the greater of 50 percent of the W-2 wages paid by the cooperative with respect to its trade or business or the sum of 25 percent of the W-2 wages of the cooperative with respect to its trade or business plus 2.5 percent of the unadjusted basis, immediately after acquisition, of qualified property of the cooperative. A specified agricultural or horticultural cooperative is an organization to which subchapter T applies that is engaged in (a) the manufacturing, production, growth, or extraction in

[97] Defined in IRC section 1(h).

whole or significant part of any agricultural or horticultural product, (b) the marketing of agricultural or horticultural products that its patrons have so manufactured, produced, grown, or extracted, or (c) the provision of supplies, equipment, or services to farmers or organizations described in the foregoing.

Special Rules and Definitions

For purposes of the provision, taxable income is determined without regard to the deduction allowable under the provision.

In the case of a partnership or S corporation, the provision applies at the partner or shareholder level. Each partner takes into account the partner's allocable share of each qualified item of income, gain, deduction, and loss, and is treated as having W-2 wages for the taxable year equal to the partner's allocable share of W-2 wages of the partnership. The partner's allocable share of W- 2 wages is required to be determined in the same manner as the partner's share of wage expenses. For example, if a partner is allocated a deductible amount of 10 percent of wages paid by the partnership to employees for the taxable year, the partner is required to be allocated 10 percent of the W-2 wages of the partnership for purposes of calculating the wage limit under this deduction. Similarly, each shareholder of an S corporation takes into account the shareholder's pro rata share of each qualified item of income, gain, deduction, and loss, and is treated as having W-2 wages for the taxable year equal to the shareholder's pro rata share of W-2 wages of the S corporation.

Qualified business income is determined without regard to any adjustments prescribed under the rules of the alternative minimum tax.

Treatment of Trusts and Estates

Trusts and estates are eligible for the 20-percent deduction under the provision. Rules similar to the rules under present-law IRC section 199 (as in effect on December 1, 2017) apply for apportioning between fiduciaries and beneficiaries any W-2 wages and unadjusted basis of qualified property under the limitation based on W-2 wages and capital.

The deduction under the provision is allowed only for federal income tax purposes.
For purposes of determining a substantial underpayment of income tax under the accuracy related penalty,[98] a substantial underpayment exists if the amount of the understatement exceeds the greater of five percent (not 10 percent) of the tax required to be shown on the return or $5,000.

Authority is provided to promulgate regulations needed to carry out the purposes of the provision, including regulations requiring, or restricting, the allocation of items of income, gain, loss, or deduction, or of wages under the provision. In addition, regulatory authority is provided to address reporting requirements appropriate under the provision, and the application of the provision in the case of tiered entities.

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[98] IRC section 6662(d)(1)(A).

Effective Dates

The provision is effective for taxable years beginning after December 31, 2017, and before January 1, 2026.

California Law (R&TC sections 17072, 17073, 17073.5, 17087.5, 17851, 19164, and 23800-23813)

California does not conform, under the PITL, to the new federal deduction for qualified business income of pass-through entities under IRC section 199A.

California conforms, under the PITL, to the definition of AGI under IRC section 62, as of the specified date of January 1, 2015,[99] with modifications, but does not conform to the federal change that does not allow the deduction for qualified business income of pass-through entities in the computation of adjusted gross income.

California conforms, under the PITL, to the definition of taxable income under IRC section 63, as of the specified date of January 1, 2015, with modifications, but does not conform to the federal change that excludes the deduction for qualified business income of pass-through entities from the definition of itemized deductions, and allows the deduction in addition to the standard deduction in determining taxable income.

California conforms, under the PITL and the CTL, to the tax treatment of S corporations and their shareholders under IRC sections 1361 through 1379, as of the specified date of January 1, 2015, with modifications. California automatically conforms to federal law regarding S corporation elections, revocations, and terminations.

California conforms, under the PITL, to the tax treatment of partners and partnerships under IRC sections 701 through 761, as of the specified date of January 1, 2015, with modifications.

California imposes, under the AFITL, an accuracy-related penalty which is determined under IRC section 6662, as of the specified date of January 1, 2015, with modifications, but does not conform to the federal change to reduce the penalty rate from 10 percent to 5 percent on the amount of income which is substantially understated related to the deduction for qualified business income of pass-through entities.

[99] R&TC section 17024.5.

Impact on California Revenue

Estimated Conformity Revenue Impact of Deduction for Qualified Business Income of Pass-Thru Entities For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	- $3,700,000,000	- $2,600,000,000	- $2,700,000,000

Section Section Title

11012 Limitation on Losses for Taxpayers Other than Corporations

Background

Loss Limitation Rules Applicable to Individuals

Passive Loss Rules

The passive loss rules limit deductions and credits from passive trade or business activities.[100] The passive loss rules apply to individuals, estates and trusts, and closely held corporations. A passive activity for this purpose is a trade or business activity in which the taxpayer owns an interest, but in which the taxpayer does not materially participate. A taxpayer is treated as materially participating in an activity only if the taxpayer is involved in the operation of the activity on a basis that is regular, continuous, and substantial.[101] Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income. Deductions and credits that are suspended under these rules are carried forward and treated as deductions and credits from passive activities in the next year. The suspended losses from a passive activity are allowed in full when a taxpayer makes a taxable disposition of his entire interest in the passive activity to an unrelated person.

Excess Farm Loss Rules

A limitation on excess farm losses applies to taxpayers other than C corporations.[102] If a taxpayer other than a C corporation receives an applicable subsidy for the taxable year, the amount of the excess farm loss is not allowed for the taxable year, and is carried forward and treated as a deduction attributable to farming businesses in the next taxable year. An excess farm loss for a

[100] IRC section 469.
[101] Regulations provide more detailed standards for material participation. See Treasury Regulation sections 1.469-5 and -5T.
[102] IRC section 461(j).

taxable year means the excess of aggregate deductions that are attributable to farming businesses over the sum of aggregate gross income or gain attributable to farming businesses plus the threshold amount. The threshold amount is the greater of (1) $300,000 ($150,000 for married individuals filing separately), or (2) for the five-consecutive-year period preceding the taxable year, the excess of the aggregate gross income or gain attributable to the taxpayer's farming businesses over the aggregate deductions attributable to the taxpayer's farming businesses.

New Federal Law (IRC section 461)

For taxable years beginning after December 31, 2017, and before January 1, 2026, excess business losses of a taxpayer other than a corporation are not allowed for the taxable year. Such losses are carried forward and treated as part of the taxpayer's net operating loss (NOL) carryforward in subsequent taxable years. Under new limitations, NOL carryovers generally are allowed for a taxable year up to the lesser of the carryover amount 80 percent of taxable income determined without regard to the deduction for NOLs.[103]

An excess business loss for the taxable year is the excess of aggregate deductions of the taxpayer attributable to trades or businesses of the taxpayer (determined without regard to the limitation of the provision), over the sum of aggregate gross income or gain of the taxpayer plus a threshold amount. The threshold amount for a taxable year is $250,000 (or twice the otherwise applicable threshold amount in the case of a joint return). The threshold amount is indexed for inflation.

In the case of a partnership or S corporation, the provision applies at the partner or shareholder level. Each partner's distributive share and each S corporation shareholder's pro rata share of items of income, gain, deduction, or loss of the partnership or S corporation are taken into account in applying the limitation under the provision for the taxable year of the partner or S corporation shareholder. Regulatory authority is also provided to require any additional reporting as the Secretary determines is appropriate to carry out the purposes of the provision.

The provision applies after the application of the passive loss rules.[104]

Effective Dates

The provision is effective for losses of other than a corporation for taxable years beginning after December 31, 2017, and before January 1, 2026. In addition, for taxable years beginning after December 31, 2017, and before January 1, 2026, the present-law limitation relating to excess farm losses does not apply.

California Law (R&TC sections 17551, 17560.5 and 24681)

California conforms, under the PITL and the CTL, to the federal rules relating to the general rule for the taxable year of deduction under IRC section 461 as of the “specified date” of

[103] IRC section 172.
[104] IRC section 469.

January 1, 2015, with modifications, but does not conform to the new federal limitation on losses for taxpayers other than corporations.

California does not conform, under the PITL, to IRC section 461(j), relating to the limitation on excess farm losses of certain taxpayers,[105] and as a result, there is no impact to conforming under the PITL, for taxable years beginning after December 31, 2017, and before January 1, 2026, to the change making the excess farm losses limitation inapplicable.

Impact on California Revenue

Estimated Conformity Revenue Impact of Limitation on Losses for Taxpayers Other Than Corporations For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	$1,100,000,000	$800,000,000	$800,000,000

Part III—Tax Benefits for Families and Individuals

Section	Section Title
11021	Increase in Standard Deduction

Background

Under present law, an individual who does not elect to itemize deductions may reduce his adjusted gross income (AGI) by the amount of the applicable standard deduction in arriving at his taxable income. The standard deduction is the sum of the basic standard deduction and, if applicable, the additional standard deduction. The basic standard deduction varies depending upon a taxpayer's filing status. For 2017, the amount of the basic standard deduction is $6,350 for single individuals and married individuals filing separate returns, $9,350 for heads of households, and $12,700 for married individuals filing a joint return and surviving spouses. An additional standard deduction is allowed with respect to any individual who is elderly or blind.[106] The amount of the standard deduction is indexed annually for inflation.

[105] R&TC sections 17560.5.
[106] For 2017, the additional amount is $1,250 for married taxpayers (for each spouse meeting the applicable criterion) and surviving spouses. The additional amount for single individuals and heads of households is $1,550. An individual who qualifies as both blind and elderly is entitled to two additional standard deductions, for a total additional amount (for 2017) of $2,500 or $3,100, as applicable.

In the case of a dependent for whom a deduction for a personal exemption is allowed to another taxpayer, the standard deduction may not exceed the greater of (i) $1,050 (in 2017) or (ii) the sum of $350 (in 2017) plus the individual's earned income.

In the case of a dependent for whom a deduction for a personal exemption is allowed to another taxpayer, the standard deduction may not exceed the greater of (i) $1,050 (in 2017) or (ii) the sum of $350 (in 2017) plus the individual's earned income.

New Federal Law

The provision increases the standard deduction for individuals across all filing statuses. Under the provision, the amount of the standard deduction is $24,000 for married individuals filing a joint return, $18,000 for head-of-household filers, and $12,000 for all other taxpayers.

The amount of the standard deduction is indexed for inflation using the C–CPI–U for taxable years beginning after December 31, 2018.[107]

Effective Dates

The provision is effective for taxable years beginning after December 31, 2017, and before January 1, 2026.

California Law (R&TC sections 17073.5 and 17304)

California does not conform to the federal standard deduction, but instead has stand-alone law allowing a California standard deduction[108] in lieu of the federal standard deduction, as follows:

Filing status	**2017 California Standard Deduction Amounts**
Single or married/registered domestic partner (RDP) filing separately	$4,236
Married/RDP filing jointly, head of household, or qualifying widow(er)	$8,472
The minimum standard deduction for dependents	$1,050

Nonresidents and part-year residents are allowed a standard deduction in the above amounts as modified by the ratio that California AGI bears to total AGI (not to exceed 100 percent).[109]

[107] Thus, the standard deduction is the same for 2018 and 2019.
[108] R&TC section 17073.5. Amounts are adjusted annually for inflation based on the California Consumer Price Index.
[109] R&TC section 17304.

Impact on California Revenue

Not applicable.

Section	Section Title
11022	Increase In and Modification of Child Tax Credit

Background

An individual may claim a tax credit for each qualifying child under the age of 17. The amount of the credit per child is $1,000. A child who is not a citizen, national, or resident of the United States cannot be a qualifying child.

The aggregate amount of child credits that may be claimed is phased out for individuals with income over certain threshold amounts. Specifically, the otherwise allowable child tax credit is reduced by $50 for each $1,000 (or fraction thereof) of modified AGI over $75,000 for single individuals or heads of households, $110,000 for married individuals filing joint returns, and $55,000 for married individuals filing separate returns. For purposes of this limitation, modified AGI includes certain otherwise excludable income earned by U.S. citizens or residents living abroad or in certain U.S. territories.

The credit is allowable against both the regular tax and the alternative minimum tax (AMT). To the extent the child credit exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit[110] (the "additional child tax credit") equal to 15 percent of earned income in excess of $3,000 (the "earned income" formula).

Families with three or more children may determine the additional child tax credit using the "alternative formula," if this results in a larger credit than determined under the earned income formula. Under the alternative formula, the additional child tax credit equals the amount by which the taxpayer's Social Security taxes exceed the taxpayer's earned income credit (EIC).

Earned income is defined as the sum of wages, salaries, tips, and other taxable employee compensation plus net self-employment earnings. At the taxpayer's election, combat pay may be treated as earned income for these purposes. Unlike the EIC, which also includes the preceding items in its definition of earned income, the additional child tax credit is based only on earned income to the extent it is included in computing taxable income. For example, some ministers' parsonage allowances are considered self-employment income, and thus are considered earned income for purposes of computing the EIC, but the allowances are excluded from gross income for individual income tax purposes, and thus are not considered earned income for purposes of the additional child tax credit since the income is not included in taxable income.

[110] The refundable credit may not exceed the maximum credit per child of $1,000.

Any credit or refund allowed or made to an individual under this provision (including to any resident of a U.S. possession) is not taken into account as income and is not to be taken into account as resources for the month of receipt and the following two months for purposes of determining eligibility of such individual or any other individual for benefits or assistance, or the amount or extent of benefits or assistance, under any federal program or under any State or local program financed in whole or in part with federal funds.

New Federal Law (IRC section 24)

The provision temporarily increases the child tax credit to $2,000 per qualifying child. The credit is further modified to temporarily provide for a $500 nonrefundable credit for qualifying dependents other than qualifying children. The provision generally retains the present-law definition of dependent.

Under the provision, the maximum amount of the credit that is refundable may not exceed $1,400 per qualifying child.[111] Additionally, the provision provides that, in order to receive the child tax credit (i.e., both the refundable and non-refundable portion), a taxpayer must include a Social Security number for each qualifying child for whom the credit is claimed on the tax return. For these purposes, a Social Security number must be issued before the due date for the filing of the return for the taxable year. This requirement does not apply to a non-child dependent for whom the $500 non-refundable credit is claimed.[112]

Further, the provision retains the present-law age limit for a qualifying child. Thus, a qualifying child is an individual who has not attained age 17 during the taxable year.

Finally, the provision modifies the adjusted gross income phaseout thresholds. Under the provision, the credit begins to phase out for taxpayers with adjusted gross income in excess of $400,000 (in the case of married taxpayers filing a joint return) and $200,000 (for all other taxpayers). These phaseout thresholds are not indexed for inflation.

Effective Dates

The provision is effective for taxable years beginning after December 31, 2017, and before January 1, 2026.

California Law

California does not conform to the child tax credit under IRC section 24, and has no comparable credit.

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[111] The provision uses an indexing convention that rounds the $1,400 amount to the next lowest multiple of $100.
[112] Additionally, a qualifying child who is ineligible to receive the child tax credit because that child did not have a Social Security number as the child's taxpayer identification number may nonetheless qualify for the non-refundable $500 credit.

Impact on California Revenue

Not applicable.

Section	Section Title
11023	Increased Limitation for Certain Charitable Contributions

Background

In General

The IRC allows taxpayers to reduce their income tax liability by taking deductions for contributions to certain organizations, including charities, federal, state, local, and Indian tribal governments, and certain other organizations.

To be deductible, a charitable contribution generally must meet several threshold requirements. First, the recipient of the transfer must be eligible to receive charitable contributions (*i.e.,* an organization or entity described in IRC section 170(c)). Second, the transfer must be made with gratuitous intent and without the expectation of a benefit of substantial economic value in return. Third, the transfer must be complete and generally must be a transfer of a donor's entire interest in the contributed property (*i.e.,* not a contingent or partial interest contribution). To qualify for a current year charitable deduction, payment of the contribution must be made within the taxable year.[113] Fourth, the transfer must be of money or property—contributions of services are not deductible.[114] Finally, the transfer must be substantiated and in the proper form.

As discussed below, special rules limit the deductibility of a taxpayer's charitable contributions in a given year to a percentage of income, and those rules, in part, turn on whether the organization receiving the contributions is a public charity or a private foundation. Other special rules determine the deductible value of contributed property for each type of property.

Contributions of Partial Interests in Property

In General

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity while retaining an interest in that property or transferring an interest in that property to a noncharity for less than full and adequate

[113] IRC section 170(a)(1).
[114] For example, as discussed in greater detail below, the value of time spent volunteering for a charitable organization is not deductible. Incidental expenses such as mileage, supplies, or other expenses incurred while volunteering for a charitable organization, however, may be deductible.

consideration.[115] This rule of nondeductibility, often referred to as the partial interest rule, generally prohibits a charitable deduction for contributions of income interests, remainder interests, or rights to use property.

A charitable contribution deduction generally is not allowable for a contribution of a future interest in tangible personal property.[116] For this purpose, a future interest is one "in which a donor purports to give tangible personal property to a charitable organization, but has an understanding, arrangement, agreement, etc., whether written or oral, with the charitable organization that has the effect of reserving to, or retaining in, such donor a right to the use, possession, or enjoyment of the property."[117]

A gift of an undivided portion of a donor's entire interest in property generally is not treated as a nondeductible gift of a partial interest in property.[118] For this purpose, an undivided portion of a donor's entire interest in property must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property and must extend over the entire term of the donor's interest in such property.[119] A gift generally is treated as a gift of an undivided portion of a donor's entire interest in property if the donee is given the right, as a tenant in common with the donor, to possession, dominion, and control of the property for a portion of each year appropriate to its interest in such property.[120]

Other exceptions to the partial interest rule are provided for, among other interests: (1) remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds; (2) present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property; (3) a remainder interest in a personal residence or farm; and (4) qualified conservation contributions.

Qualified Conservation Contributions

Qualified conservation contributions are not subject to the partial interest rule, which generally bars deductions for charitable contributions of partial interests in property.[121] A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property

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[115] IRC sections 170(f)(3)(A) (income tax), 2055(e)(2) (estate tax), and 2522(c)(2) (gift tax).
[116] IRC section 170(a)(3).
[117] Treasury Regulation section 1.170A-5(a)(4). Treasury regulations provide that IRC section 170(a)(3), which generally denies a deduction for a contribution of a future interest in tangible personal property, has ''no application in respect of a transfer of an undivided present interest in property. For example, a contribution of an undivided one-quarter interest in a painting with respect to which the donee is entitled to possession during three months of each year shall be treated as made upon the receipt by the donee of a formally executed and acknowledged deed of gift. However, the period of initial possession by the donee may not be deferred in time for more than one year." Treasury Regulation section 1.170A-5(a)(2).
[118] IRC section 170(f)(3)(B)(ii).
[119] Treasury Regulation section 1.170A-7(b)(1).
[120] Treasury Regulation section 1.170A-7(b)(1).
[121] IRC sections 170(f)(3)(B)(iii) and 170(h).

(generally, a conservation easement). Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.

Percentage Limits on Charitable Contributions

Individual Taxpayers

Charitable contributions by individual taxpayers are limited to a specified percentage of the individual's contribution base. The contribution base is the taxpayer's AGI for a taxable year, disregarding any net operating loss carryback to the year under IRC section 172.[122] In general, more favorable (higher) percentage limits apply to contributions of cash and ordinary income property than to contributions of capital gain property. More favorable limits also generally apply to contributions to public charities (and certain operating foundations) than to contributions to nonoperating private foundations.

More specifically, the deduction for charitable contributions by an individual taxpayer of cash and property that is not appreciated to a charitable organization described in IRC section 170(b)(1)(A) (public charities, private foundations other than nonoperating private foundations, and certain governmental units) may not exceed 50 percent of the taxpayer's contribution base. Contributions of this type of property to nonoperating private foundations generally may be deducted up to the lesser of 30 percent of the taxpayer's contribution base or the excess of (i) 50 percent of the contribution base over (ii) the amount of contributions subject to the 50 percent limitation.

Contributions of appreciated capital gain property to public charities and other organizations described in IRC section 170(b)(1)(A) generally are deductible up to 30 percent of the taxpayer's contribution base (after taking into account contributions other than contributions of capital gain property). An individual may elect, however, to bring all these contributions of appreciated capital gain property for a taxable year within the 50-percent limitation category by reducing the amount of the contribution deduction by the amount of the appreciation in the capital gain property. Contributions of appreciated capital gain property to nonoperating private foundations are deductible up to the lesser of 20 percent of the taxpayer's contribution base or the excess of (i) 30 percent of the contribution base over (ii) the amount of contributions subject to the 30 percent limitation.

Finally, contributions that are for the use of (not to) the donee charity get less favorable percentage limits. Contributions of capital gain property for the use of public charities and other organizations described in IRC section 170(b)(1)(A) also are limited to 20 percent of the taxpayer's

[122] IRC section 170(b)(1)(G).

contribution base. Property contributed for the use of an organization generally has been interpreted to mean property contributed in trust for the organization.[123] Charitable contributions of income interests (where deductible) also generally are treated as contributions for the use of the donee organization.

TABLE 3.—CHARITABLE CONTRIBUTION PERCENTAGE LIMITS FOR INDIVIDUAL TAXPAYERS[124]

	Ordinary Income Property and Cash	Capital Gain Property to the Recipient[125]	Capital Gain Property for the use of the Recipient
Public Charities, Private Operating Foundations, and Private Distributing Foundations	50%	30% [126]	20%
Nonoperating Private Foundations	30%	20%	20%

Corporate Taxpayers

A corporation generally may deduct charitable contributions up to 10 percent of the corporation's taxable income for the year.[127] For this purpose, taxable income is determined without regard to: (1) the charitable contributions deduction; (2) any net operating loss carryback to the taxable year; (3) deductions for dividends received; (4) deductions for dividends paid on certain preferred stock of public utilities; and (5) any capital loss carryback to the taxable year.[128]

Carryforwards of Excess Contributions

Charitable contributions that exceed the applicable percentage limit generally may be carried forward for up to five years.[129] In general, contributions carried over from a prior year are taken into account after contributions for the current year that are subject to the same percentage limit. Excess contributions made for the use of (rather than to) an organization generally may not be carried forward.

[123] *Rockefeller v. Commissioner*, 676 F.2d 35, 39 (2d Cir. 1982).
[124] Percentages shown are the percentage of an individual's contribution base.
[125] Capital gain property contributed to public charities, private operating foundations, or private distributing foundations will be subject to the 50-percent limitation if the donor elects to reduce the fair market value of the property by the amount that would have been long-term capital gain if the property had been sold.
[126] Certain qualified conservation contributions to public charities (generally, conservation easements), qualify for more generous contribution limits. In general, the 30-percent limit applicable to contributions of capital gain property is increased to 100 percent if the individual making the qualified conservation contribution is a qualified farmer or rancher or to 50 percent if the individual is not a qualified farmer or rancher.
[127] IRC section 170(b)(2)(A).
[128] IRC section 170(b)(2)(C).
[129] IRC section 170(d).

Qualified Conservation Contributions

Preferential percentage limits and carryforward rules apply for qualified conservation contributions.[130] In general, the 30-percent contribution base limitation on contributions of capital gain property by individuals does not apply to qualified conservation contributions. Instead, individuals may deduct the fair market value of any qualified conservation contribution to an organization described in IRC section 170(b)(1)(A) (generally, public charities) to the extent of the excess of 50 percent of the contribution base over the amount of all other allowable charitable contributions. These contributions are not taken into account in determining the amount of other allowable charitable contributions. Individuals are allowed to carry forward any qualified conservation contributions that exceed the 50-percent limitation for up to 15 years. In the case of an individual who is a qualified farmer or rancher for the taxable year in which the contribution is made, a qualified conservation contribution is allowable up to 100 percent of the excess of the taxpayer's contribution base over the amount of all other allowable charitable contributions.

In the case of a corporation (other than a publicly traded corporation) that is a qualified farmer or rancher for the taxable year in which the contribution is made, any qualified conservation contribution is allowable up to 100 percent of the excess of the corporation's taxable income (as computed under IRC section 170(b)(2)) over the amount of all other allowable charitable contributions. Any excess may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.[131]

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

Valuation of Charitable Contributions

In General

For purposes of the income tax charitable deduction, the value of property contributed to charity may be limited to the fair market value of the property, the donor's tax basis in the property, or in some cases a different amount.

Charitable contributions of cash are deductible in the amount contributed, subject to the percentage limits discussed above. In addition, a taxpayer generally may deduct the full fair market value of long-term capital gain property contributed to charity.[132] Contributions of tangible personal property also generally are deductible at fair market value if the use by the recipient charitable organization is related to its tax-exempt purpose.

In certain other cases, however, IRC section 170(e) limits the deductible value of the contribution of appreciated property to the donor's tax basis in the property. This limitation of the property's

[130] IRC section 170(b)(1)(E).
[131] IRC section 170(b)(2)(B).
[132] Capital gain property means any capital asset or property used in the taxpayer's trade or business, the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. IRC section 170(e)(1)(A).

deductible value to basis generally applies, for example, for: (1) contributions of inventory or other ordinary income or short-term capital gain property;[133] (2) contributions of tangible personal property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose;[134] and (3) contributions to or for the use of a private foundation (other than certain private operating foundations).[135]

For contributions of qualified appreciated stock, the above-described rule that limits the value of property contributed to or for the use of a private nonoperating foundation to the taxpayer's basis in the property does not apply; therefore, subject to certain limits, contributions of qualified appreciated stock to a nonoperating private foundation may be deducted at fair market value.[136] Qualified appreciated stock is stock that is capital gain property and for which (as of the date of the contribution) market quotations are readily available on an established securities market.[137] A contribution of qualified appreciated stock (when increased by the aggregate amount of all prior such contributions by the donor of stock in the corporation) generally does not include a contribution of stock to the extent the amount of the stock contributed exceeds 10 percent (in value) of all of the outstanding stock of the corporation.[138]

Contributions of property with a fair market value that is less than the donor's tax basis generally are deductible at the fair market value of the property.

Enhanced Deduction Rules for Certain Contributions of Inventory and Other Property

Although most charitable contributions of property are valued at fair market value or the donor's tax basis in the property, certain statutorily described contributions of appreciated inventory and other property qualify for an enhanced deduction valuation that exceeds the donor's tax basis in the property, but which is less than the fair market value of the property.

As discussed above, a taxpayer's deduction for charitable contributions of inventory property generally is limited to the taxpayer's basis (typically, cost) in the inventory, or if less, the fair market value of the property. For certain contributions of inventory, however, C corporations (but not other taxpayers) may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one-half of fair market value in excess of basis) or (2) two times basis.[139] To be eligible for the enhanced deduction value, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in IRC section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent

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133 IRC section 170(e). Special rules, discussed below, apply for certain contributions of inventory and other property.
134 IRC section 170(e)(1)(B)(i)(I).
135 IRC section 170(e)(1)(B)(ii). Certain contributions of patents or other intellectual property also generally are limited to the donor's basis in the property. IRC section 170(e)(1)(B)(iii). However, a special rule permits additional charitable deductions beyond the donor's tax basis in certain situations.
136 IRC section 170(e)(5).
137 IRC section 170(e)(5)(B).
138 IRC section 170(e)(5)(C).
139 IRC section 170(e)(3).

with such requirements.[140] Contributions to organizations that are not described in IRC section 501(c)(3), such as governmental entities, do not qualify for this enhanced deduction.

To use the enhanced deduction provision, the taxpayer must establish that the fair market value of the donated item exceeds basis.

A taxpayer engaged in a trade or business, whether or not a C corporation, is eligible to claim the enhanced deduction for certain donations of food inventory.[141]

Selected Statutory Rules for Specific Types of Contributions

Special statutory rules limit the deductible value (and impose enhanced reporting obligations on donors) of charitable contributions of certain types of property, including vehicles, intellectual property, and clothing and household items. Each of these rules was enacted in response to concerns that some taxpayers did not accurately report, and in many instances overstated, the value of the property for purposes of claiming a charitable deduction.

<u>Vehicle donations</u>. Under present law, the amount of deduction for charitable contributions of vehicles (generally including automobiles, boats, and airplanes for which the claimed value exceeds $500 and excluding inventory property) depends upon the use of the vehicle by the donee organization. If the donee organization sells the vehicle without any significant intervening use or material improvement of such vehicle by the organization, the amount of the deduction may not exceed the gross proceeds received from the sale. In other situations, a fair market value deduction may be allowed.

Patents and other intellectual property. If a taxpayer contributes a patent or other intellectual property (other than certain copyrights or inventory)[142] to a charitable organization, the taxpayer's initial charitable deduction is limited to the lesser of the taxpayer's basis in the contributed property or the fair market value of the property.[143] In addition, the taxpayer generally is permitted to deduct, as a charitable contribution, certain additional amounts in the year of contribution or in subsequent taxable years based on a specified percentage of the qualified donee income received or accrued by the charitable donee with respect to the contributed intellectual property. For this purpose, qualified donee income includes net income received or accrued by the donee that properly is allocable to the intellectual property itself (as opposed to the activity in which the intellectual property is used).[144]

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[140] IRC section 170(e)(3)(A)(i)-(iii).
[141] IRC section 170(e)(3)(C).
[142] Under present and prior law, certain copyrights are not considered capital assets, such that the charitable deduction for such copyrights generally is limited to the taxpayer's basis. See IRC sections 1221(a)(3), 1231(b)(1)(C).
[143] IRC section 170(e)(1)(B)(iii).
[144] The present-law rules allowing additional charitable deductions for qualified donee income were enacted as part of the American Jobs Creation Act of 2004, and are effective for contributions made after June 3, 2004. For a more detailed description of these rules, see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress* (JCS-5-05), May 2005, pp. 457-461.

Clothing and household items. Charitable contributions of clothing and household items generally are subject to the charitable deduction rules applicable to tangible personal property. If such contributed property is appreciated property in the hands of the taxpayer, and is not used to further the donee's exempt purpose, the deduction is limited to basis. In most situations, however, clothing and household items have a fair market value that is less than the taxpayer's basis in the property. Because property with a fair market value less than basis generally is deductible at the property's fair market value, taxpayers generally may deduct only the fair market value of most contributions of clothing or household items, regardless of whether the property is used for exempt or unrelated purposes by the donee organization. Furthermore, a special rule generally provides that no deduction is allowed for a charitable contribution of clothing or a household item unless the item is in good used or better condition. The Secretary is authorized to deny by regulation a deduction for any contribution of clothing or a household item that has minimal monetary value, such as used socks and used undergarments. Notwithstanding the general rule, a charitable contribution of clothing or household items not in good used or better condition with a claimed value of more than $500 may be deducted if the taxpayer includes with the taxpayer's return a qualified appraisal with respect to the property.[145] Household items include furniture, furnishings, electronics, appliances, linens, and other similar items. Food, paintings, antiques, and other objects of art, jewelry and gems, and certain collections are excluded from the special rules described in the preceding paragraph.[146]

Use of a Vehicle When Volunteering for a Charity

Unreimbursed out-of-pocket expenditures made incident to providing donated services to a qualified charitable organization, such as out-of-pocket transportation expenses necessarily incurred in performing donated services, may qualify as a charitable contribution.[147] No charitable contribution deduction is allowed for traveling expenses (including expenses for meals and lodging) while away from home, whether paid directly or by reimbursement, unless there is no significant element of personal pleasure, recreation, or vacation in such travel.[148]

In determining the amount treated as a charitable contribution where a taxpayer operates a vehicle in providing donated services to a charity, the taxpayer either may track and deduct actual out-of-pocket expenditures or, in the case of a passenger automobile, may use the charitable standard mileage rate. The charitable standard mileage rate is set by statute at 14 cents per mile.[149] The taxpayer may also deduct (under either computation method), any parking fees and tolls incurred in rendering the services, but may not deduct any amount (regardless of the computation method used) for general repair or maintenance expenses, depreciation, insurance, registration fees, etc. Regardless of the computation method used, the taxpayer must keep reliable written records of expenses incurred. For example, where a taxpayer uses the charitable

[145] As is discussed above, the charitable contribution substantiation rules generally require a qualified appraisal where the claimed value of a contribution is more than $5,000.
[146] The special rules concerning the deductibility of clothing and household items were enacted as part of the Pension Protection Act of 2006, P.L. 109-280 (August 17, 2006), and are effective for contributions made after August 17, 2006. For a more detailed description of these rules, see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 109th Congress* (JCS-1-07), January 17, 2007, pp. 597-600.
[147] Treasury Regulation section 1.170A-1(g).
[148] IRC section 170(j).
[149] IRC section 170(i).

standard mileage rate to determine a deduction, the IRS has stated that the taxpayer generally must maintain records of miles driven, time, place (or use), and purpose of the mileage. If the charitable standard mileage rate is not used to determine the deduction, the taxpayer generally must maintain reliable written records of actual expenses incurred.[150]

Substantiation and Other Formal Requirements

In General

A donor who claims a deduction for a charitable contribution must maintain reliable written records regarding the contribution, regardless of the value or amount of such contribution.[151] In the case of a charitable contribution of money, regardless of the amount, applicable recordkeeping requirements are satisfied only if the donor maintains as a record of the contribution a bank record or a written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution. In such cases, the recordkeeping requirements may not be satisfied by maintaining other written records.

No charitable contribution deduction is allowed for a separate contribution of $250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.[152]

In addition, any charity receiving a contribution exceeding $75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a “quid pro quo” contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services is deductible as a charitable contribution.[153]

If the total charitable deduction claimed for noncash property is more than $500, the taxpayer must attach a completed Form 8283 (Noncash Charitable Contributions) to the taxpayer's return or the deduction is not allowed.[154] In general, taxpayers are required to obtain a qualified appraisal for donated property with a value of more than $5,000, and to attach an appraisal summary to the tax return.

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[150] In lieu of actual operating expenses, an optional standard mileage rate may be used in computing deductible transportation expenses for medical purposes (section 213) or for work-related moving (section 217). The standard mileage rates for medical and moving purposes generally cover only out-of-pocket operating expenses (including gasoline and oil) directly related to the use of the automobile. Such rates do not include costs that are not deductible for medical or moving purposes, such as general maintenance expenses, depreciation, insurance, and registration fees. The medical and moving standard mileage rates are determined by the IRS and updated periodically. For expenses paid or incurred on or after January 1, 2017, the rate for both such purposes is 17 cents per mile. IRS Notice 2016-79.

[151] IRC section 170(f)(17).

[152] Such acknowledgement must include the amount of cash and a description (but not value) of any property other than cash contributed, whether the donee provided any goods or services in consideration for the contribution, and a good faith estimate of the value of any such goods or services. IRC section 170(f)(8).

[153] IRC section 6115.

[154] IRC section 170(f)(11).

Exception for Certain Contributions Reported by the Donee Organization

Subsection 170(f)(8)(D) provides an exception to the contemporaneous written acknowledgment requirement described above. Under the exception, a contemporaneous written acknowledgment is not required if the donee organization files a return, on such form and in accordance with such regulations as the Secretary may prescribe, that includes the same content. "[T]he section 170(f)(8)(D) exception is not available unless and until the Treasury Department and the IRS issue final regulations prescribing the method by which donee reporting may be accomplished."[155] No such final regulations have been issued.[156]

New Federal Law IRC section 170)

The provision increases the income-based percentage limit described in section 170(b)(1)(A) for certain charitable contributions by an individual taxpayer of cash to public charities and certain other organizations from 50 percent to 60 percent.

Effective Dates

The provision is effective for contributions made in taxable years beginning after December 31, 2017, and before January 1, 2026.

California Law (R&TC sections 17201, 17275.2 – 17275.5, and 24357 – 24359.1)

California generally conforms, under the PITL, to the federal charitable contribution rules under IRC section 170 as of the "specified date" of January 1, 2015, with modifications,[157] and as a result, does not conform to the increased limitation for certain charitable contributions.

California has stand-alone law, under the CTL, for corporate charitable contribution deductions that incorporates some of the federal contribution rules by reference.[158] In general, in any taxable year, charitable contributions by a corporation are not deductible to the extent the aggregate contributions exceed 10 percent of the corporation's net income computed without regard to net

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[155] See IRS, Notice of Proposed Rulemaking, Substantiation Requirement for Certain Contributions, REG-138344-13 (October 13, 2015), I.R.B. 2015-41 (preamble).
[156] In October 2015, the IRS issued proposed regulations that, if finalized, would have implemented the section 170(f)(8)(D) exception to the contemporaneous written acknowledgment requirement. The proposed regulations provided that a return filed by a donee organization under section 170(f)(8)(D) must include, in addition to the information generally required on a contemporaneous written acknowledgment: (1) the name and address of the donee organization; (2) the name and address of the donor; and (3) the taxpayer identification number of the donor. In addition, the return must be filed with the IRS (with a copy provided to the donor) on or before February 28 of the year following the calendar year in which the contribution was made. Under the proposed regulations, donee reporting would have been optional and would have been available solely at the discretion of the donee organization. The proposed regulations were withdrawn in January 2016. See Prop. Treas. Reg. sec 1.170A-13(f)(18).
[157] R&TC sections 17275.2–17275.5.
[158] R&TC sections 24357-24357.9.

operating or capital loss carrybacks, and any excess may be carried forward for up to five years.[159] As a result, California does not conform to the increased limitation for certain charitable contributions for corporations.

Impact on California Revenue

Estimated Conformity Revenue Impact of Increased Limitation for Certain Charitable Contributions For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	- $22,000,000	- $15,000,000	- $15,000,000

Section	Section Title
11024	Increased Contributions to ABLE Accounts

Background

Qualified ABLE Programs

The IRC provides for a tax-favored savings program intended to benefit disabled individuals, known as qualified ABLE programs.[160] A qualified ABLE program is a program established and maintained by a State or agency or instrumentality thereof. A qualified ABLE program must meet the following conditions: (1) under the provisions of the program, contributions may be made to an account (an "ABLE account"), established for the purpose of meeting the qualified disability expenses of the designated beneficiary of the account; (2) the program must limit a designated beneficiary to one ABLE account; and (3) the program must meet certain other requirements discussed below. A qualified ABLE program is generally exempt from income tax, but is otherwise subject to the taxes imposed on the unrelated business income of tax-exempt organizations.

A designated beneficiary of an ABLE account is the owner of the ABLE account. A designated beneficiary must be an eligible individual (defined below) who established the ABLE account and who is designated at the commencement of participation in the qualified ABLE program as the beneficiary of amounts paid (or to be paid) into and from the program.

Contributions to an ABLE account must be made in cash and are not deductible for Federal income tax purposes. Except in the case of a rollover contribution from another ABLE account, an ABLE account must provide that it may not receive aggregate contributions during a taxable year in excess of the amount under section 2503(b) of the IRC (the annual gift tax exemption). For

[159] R&TC section 24357.
[160] IRC section 529A.

2017, this is $14,000.[161] Additionally, a qualified ABLE program must provide adequate safeguards to ensure that ABLE account contributions do not exceed the limit imposed on accounts under the qualified tuition program of the State maintaining the qualified ABLE program. Amounts in the account accumulate on a tax-deferred basis (i.e., income on accounts under the program is not subject to current income tax).

A qualified ABLE program may permit a designated beneficiary to direct (directly or indirectly) the investment of any contributions (or earnings thereon) no more than two times in any calendar year and must provide separate accounting for each designated beneficiary. A qualified ABLE program may not allow any interest in the program (or any portion thereof) to be used as security for a loan. Distributions from an ABLE account are generally includible in the distributee's income to the extent consisting of earnings on the account.[162] Distributions from an ABLE account are excludable from income to the extent that the total distribution does not exceed the qualified disability expenses of the designated beneficiary during the taxable year. If a distribution from an ABLE account exceeds the qualified disability expenses of the designated beneficiary, a pro rata portion of the distribution is excludable from income. The portion of any distribution that is includible in income is subject to an additional 10-percent tax unless the distribution is made after the death of the beneficiary. Amounts in an ABLE account may be rolled over without income tax liability to another ABLE account for the same beneficiary[163] or another ABLE account for the designated beneficiary's brother, sister, stepbrother or stepsister who is also an eligible individual.

Except in the case of an ABLE account established in a different ABLE program for purposes of transferring ABLE accounts,[164] no more than one ABLE account may be established by a designated beneficiary. Thus, once an ABLE account has been established by a designated beneficiary, no account subsequently established by such beneficiary shall be treated as an ABLE account.

A contribution to an ABLE account is treated as a completed gift of a present interest to the designated beneficiary of the account. Such contributions qualify for the per-donee annual gift tax exclusion ($14,000 for 2017) and, to the extent of such exclusion, are exempt from the generation skipping transfer (GST) tax. A distribution from an ABLE account generally is not subject to gift tax or GST tax.

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[161] This amount is indexed for inflation. In the case that contributions to an ABLE account exceed the annual limit, an excise tax in the amount of six percent of the excess contribution to such account is imposed on the designated beneficiary. Such tax does not apply in the event that the trustee of such account makes a corrective distribution of such excess amounts by the due date (including extensions) of the individual's tax return for the year within the taxable year.

[162] The rules of IRC section 72 apply in determining the portion of a distribution that consists of earnings.

[163] For instance, if a designated beneficiary were to relocate to a different State.

[164] In which case the contributor ABLE account must be closed 60 days after the transfer to the new ABLE account is made.

Eligible Individuals

As described above, a qualified ABLE program may provide for the establishment of ABLE accounts only if those accounts are established and owned by an eligible individual, such owner referred to as a designated beneficiary. For these purposes, an eligible individual is an individual either (1) for whom a disability certification has been filed with the Secretary for the taxable year, or (2) who is entitled to Social Security Disability Insurance benefits or SSI benefits[165] based on blindness or disability, and such blindness or disability occurred before the individual attained age 26.

A disability certification means a certification to the satisfaction of the Secretary, made by the eligible individual or the parent or guardian of the eligible individual, that the individual has a medically determinable physical or mental impairment, which results in marked and severe functional limitations, and which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months, or is blind (within the meaning of section 1614(a)(2) of the Social Security Act). Such blindness or disability must have occurred before the date the individual attained age 26. Such certification must include a copy of the diagnosis of the individual's impairment and be signed by a licensed physician.[166]

Qualified Disability Expenses

As described above, the earnings on distributions from an ABLE account are excluded from income only to the extent total distributions do not exceed the qualified disability expenses of the designated beneficiary. For this purpose, qualified disability expenses are any expenses related to the eligible individual's blindness or disability which are made for the benefit of the designated beneficiary. Such expenses include the following expenses: education, housing, transportation, employment training and support, assistive technology and personal support services, health, prevention and wellness, financial management and administrative services, legal fees, expenses for oversight and monitoring, funeral and burial expenses, and other expenses, which are approved by the Secretary under regulations and consistent with the purposes of section 529A.

Transfer to State

In the event that the designated beneficiary dies, subject to any outstanding payments due for qualified disability expenses incurred by the designated beneficiary, all amounts remaining in the deceased designated beneficiary's ABLE account not in excess of the amount equal to the total medical assistance paid such individual under any State Medicaid plan established under title XIX of the Social Security Act shall be distributed to such State upon filing of a claim for payment by such State. Such repaid amounts shall be net of any premiums paid from the account or by or on behalf of the beneficiary to the State's Medicaid Buy-In program.

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[165] These are benefits, respectively, under Title II or Title XVI of the Social Security Act.
[166] No inference may be drawn from a disability certification for purposes of eligibility for Social Security, SSI or Medicaid benefits.

Treatment of ABLE Accounts under Federal Programs

Any amounts in an ABLE account, and any distribution for qualified disability expenses, shall be disregarded for purposes of determining eligibility to receive, or the amount of, any assistance or benefit authorized by any Federal means-tested program. However, in the case of the SSI program, a distribution for housing expenses is not disregarded, nor are amounts in an ABLE account in excess of $100,000. In the case that an individual's ABLE account balance exceeds $100,000, such individual's SSI benefits shall not be terminated, but instead shall be suspended until such time as the individual's resources fall below $100,000. However, such suspension shall not apply for purposes of Medicaid eligibility.

Saver's Credit

Present law provides a nonrefundable tax credit for eligible taxpayers for qualified retirement savings contributions.[167] The maximum annual contribution eligible for the credit is $2,000 per individual. The credit rate depends on the AGI of the taxpayer. For this purpose, AGI is determined without regard to certain excludable foreign-source earned income and certain U.S. possession income.

For taxable years beginning in 2017, married taxpayers filing joint returns with AGI of $61,500 or less, taxpayers filing head of household returns with AGI of $46,125 or less, and all other taxpayers filing returns with AGI of $30,750 or less are eligible for the credit. As the taxpayer's AGI increases, the credit rate available to the taxpayer is reduced, until, at certain AGI levels, the credit is unavailable. The credit rates based on AGI for taxable years beginning in 2016 are provided in the table below. The AGI levels used for the determination of the available credit rate are indexed for inflation.

Credit Rates for Saver's Credit

Joint Filers	Heads of Households	All Other Filers	Credit Rate
$0 – $37,000	$0 – $27,750	$0 – $18,500	50 percent
$37,001 – $40,000	$27,751 – $30,000	$18,501 – $20,000	20 percent
$40,001 – $62,000	$30,001 – $46,500	$20,001 – $31,000	10 percent
Over $62,000	Over $46,500	Over $31,000	0 percent

The saver's credit is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The credit offsets alternative minimum tax liability as well as regular tax liability. The credit is available to individuals who are 18 years old or older, other than individuals who are full-time students or claimed as a dependent on another taxpayer's return.

Qualified retirement savings contributions consist of (1) elective deferrals to an IRC section 401(k) plan, an IRC section 403(b) plan, a governmental IRC section 457 plan, a SIMPLE plan, or a SARSEP; (2) contributions to a traditional or Roth IRA; and (3) voluntary after-tax employee

[167] IRC section 25B.

contributions to a qualified retirement plan or IRC section 403(b) plan. Under the rules governing these arrangements, an individual's contribution to the arrangement generally cannot exceed the lesser of an annual dollar amount (for example, in 2017, $5,500 in the case of an IRA of an individual under age 50) or the individual's compensation that is includible in income. In the case of IRA contributions of a married couple, the combined includible compensation of both spouses may be taken into account.

The amount of any contribution eligible for the credit is reduced by distributions received by the taxpayer (or by the taxpayer's spouse if the taxpayer files a joint return with the spouse) from any retirement plan to which eligible contributions can be made during the taxable year for which the credit is claimed, during the two taxable years prior to the year for which the credit is claimed, and during the period after the end of the taxable year for which the credit is claimed and prior to the due date (including extensions) for filing the taxpayer's return for the year. Distributions that are rolled over to another retirement plan do not affect the credit.

<u>New Federal Law (IRC section 25B and 529A)</u>

The provision increases the contribution limitation to ABLE accounts under certain circumstances. While the general overall limitation on contributions (the per-donee annual gift tax exclusion ($14,000 for 2017)) remains the same, the limitation is increased with respect to contributions made by the designated beneficiary of the ABLE account. Under the provision, after the overall limitation on contributions is reached, an ABLE account's designated beneficiary may contribute an additional amount, up to the lesser of (a) the Federal poverty line for a one-person household; or (b) the individual's compensation for the taxable year.

Additionally, the provision allows a designated beneficiary of an ABLE account to claim the saver's credit for contributions made to his or her ABLE account.

<u>Effective Dates</u>

For contribution increases related to beneficiary compensation, the provision applies to taxable years beginning after December 22, 2017, and ends for contribution increases made before January 1, 2026.

For the provision allowing the saver's credit for ABLE contributions, the provision applies to taxable years beginning after December 22, 2017, and ends for contributions made before January 1, 2026.

<u>California Law (R&TC section 17140.4)</u>

California conforms, under the PITL, relating to qualified ABLE programs and accounts under IRC section 529A, as of the "specified date" of January 1, 2015,[168] with modifications, but does not conform to the increased contribution limitation to ABLE accounts under certain circumstances.

[168] R&TC section 17024.5.

California does not conform to the saver's credit under IRC section 25B, and has no comparable credit.

Impact on California Revenue

Estimated Conformity Revenue Impact of Increased Contributions to ABLE Accounts For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	- $400,000	- $200,000	- $200,000

Section	Section Title
11025	Rollovers to ABLE Programs from 529 Programs

Background

Qualified ABLE Programs

The IRC provides for a tax-favored savings program intended to benefit disabled individuals, known as qualified ABLE programs.[169] A qualified ABLE program is a program established and maintained by a State or agency or instrumentality thereof. A qualified ABLE program must meet the following conditions: (1) under the provisions of the program, contributions may be made to an account (an "ABLE account"), established for the purpose of meeting the qualified disability expenses of the designated beneficiary of the account; (2) the program must limit a designated beneficiary to one ABLE account; and (3) the program must meet certain other requirements discussed below. A qualified ABLE program is generally exempt from income tax, but is otherwise subject to the taxes imposed on the unrelated business income of tax-exempt organizations.

A designated beneficiary of an ABLE account is the owner of the ABLE account. A designated beneficiary must be an eligible individual (defined below) who established the ABLE account and who is designated at the commencement of participation in the qualified ABLE program as the beneficiary of amounts paid (or to be paid) into and from the program.

Contributions to an ABLE account must be made in cash and are not deductible for federal income tax purposes. Except in the case of a rollover contribution from another ABLE account, an ABLE account must provide that it may not receive aggregate contributions during a taxable year in excess of the amount under IRC section 2503(b) (the annual gift tax exemption). For 2017, this

[169] IRC section 529A.

is $14,000.[170] Additionally, a qualified ABLE program must provide adequate safeguards to ensure that ABLE account contributions do not exceed the limit imposed on accounts under the qualified tuition program of the State maintaining the qualified ABLE program. Amounts in the account accumulate on a tax-deferred basis (*i.e.*, income on accounts under the program is not subject to current income tax).

A qualified ABLE program may permit a designated beneficiary to direct (directly or indirectly) the investment of any contributions (or earnings thereon) no more than two times in any calendar year and must provide separate accounting for each designated beneficiary. A qualified ABLE program may not allow any interest in the program (or any portion thereof) to be used as security for a loan.

Distributions from an ABLE account are generally includible in the distributee's income to the extent consisting of earnings on the account.[171] Distributions from an ABLE account are excludable from income to the extent that the total distribution does not exceed the qualified disability expenses of the designated beneficiary during the taxable year. If a distribution from an ABLE account exceeds the qualified disability expenses of the designated beneficiary, a pro rata portion of the distribution is excludable from income. The portion of any distribution that is includible in income is subject to an additional 10-percent tax unless the distribution is made after the death of the beneficiary. Amounts in an ABLE account may be rolled over without income tax liability to another ABLE account for the same beneficiary [172] or another ABLE account for the designated beneficiary's brother, sister, stepbrother or stepsister who is also an eligible individual.

Except in the case of an ABLE account established in a different ABLE program for purposes of transferring ABLE accounts,[173] no more than one ABLE account may be established by a designated beneficiary. Thus, once an ABLE account has been established by a designated beneficiary, no account subsequently established by such beneficiary shall be treated as an ABLE account.

A contribution to an ABLE account is treated as a completed gift of a present interest to the designated beneficiary of the account. Such contributions qualify for the per-donee annual gift tax exclusion ($14,000 for 2017) and, to the extent of such exclusion, are exempt from the generation skipping transfer ("GST") tax. A distribution from an ABLE account generally is not subject to gift tax or GST tax.

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[170] This amount is indexed for inflation. In the case that contributions to an ABLE account exceed the annual limit, an excise tax in the amount of six percent of the excess contribution to such account is imposed on the designated beneficiary. Such tax does not apply in the event that the trustee of such account makes a corrective distribution of such excess amounts by the due date (including extensions) of the individual's tax return for the year within the taxable year.
[171] The rules of section 72 apply in determining the portion of a distribution that consists of earnings.
[172] For instance, if a designated beneficiary were to relocate to a different State.
[173] In which case the contributor ABLE account must be closed 60 days after the transfer to the new ABLE account is made.

Eligible Individuals

As described above, a qualified ABLE program may provide for the establishment of ABLE accounts only if those accounts are established and owned by an eligible individual, such owner referred to as a designated beneficiary. For these purposes, an eligible individual is an individual either (1) for whom a disability certification has been filed with the Secretary for the taxable year, or (2) who is entitled to Social Security Disability Insurance benefits or SSI benefits[174] based on blindness or disability, and such blindness or disability occurred before the individual attained age 26.

A disability certification means a certification to the satisfaction of the Secretary, made by the eligible individual or the parent or guardian of the eligible individual, that the individual has a medically determinable physical or mental impairment, which results in marked and severe functional limitations, and which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months, or is blind (within the meaning of section 1614(a)(2) of the Social Security Act). Such blindness or disability must have occurred before the date the individual attained age 26. Such certification must include a copy of the diagnosis of the individual's impairment and be signed by a licensed physician.[175]

Qualified Disability Expenses

As described above, the earnings on distributions from an ABLE account are excluded from income only to the extent total distributions do not exceed the qualified disability expenses of the designated beneficiary. For this purpose, qualified disability expenses are any expenses related to the eligible individual's blindness or disability which are made for the benefit of the designated beneficiary. Such expenses include the following expenses: education, housing, transportation, employment training and support, assistive technology and personal support services, health, prevention and wellness, financial management and administrative services, legal fees, expenses for oversight and monitoring, funeral and burial expenses, and other expenses, which are approved by the Secretary under regulations and consistent with the purposes of section 529A.

Transfer to State

In the event that the designated beneficiary dies, subject to any outstanding payments due for qualified disability expenses incurred by the designated beneficiary, all amounts remaining in the deceased designated beneficiary's ABLE account not in excess of the amount equal to the total medical assistance paid such individual under any State Medicaid plan established under title XIX of the Social Security Act shall be distributed to such State upon filing of a claim for payment by such State. Such repaid amounts shall be net of any premiums paid from the account or by or on behalf of the beneficiary to the State's Medicaid Buy-In program.

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[174] These are benefits, respectively, under Title II or Title XVI of the Social Security Act.
[175] No inference may be drawn from a disability certification for purposes of eligibility for Social Security, SSI or Medicaid benefits.

Treatment of ABLE Accounts under Federal Programs

Any amounts in an ABLE account, and any distribution for qualified disability expenses, shall be disregarded for purposes of determining eligibility to receive, or the amount of, any assistance or benefit authorized by any federal means-tested program. However, in the case of the SSI program, a distribution for housing expenses is not disregarded, nor are amounts in an ABLE account in excess of $100,000. In the case that an individual's ABLE account balance exceeds $100,000, such individual's SSI benefits shall not be terminated, but instead shall be suspended until such time as the individual's resources fall below $100,000. However, such suspension shall not apply for purposes of Medicaid eligibility.

New Federal Law (IRC section 529)

The provision allows for amounts from qualified tuition programs (also known as 529 accounts) to be rolled over to an ABLE account without penalty, provided that the ABLE account is owned by the designated beneficiary of that 529 account, or a member of such designated beneficiary's family.[176] Such rolled-over amounts count towards the overall limitation on amounts that can be contributed to an ABLE account within a taxable year.[177] [178] Any amount rolled over that is in excess of this limitation shall be includible in the gross income of the distributee in a manner provided by section 72.[179]

Effective Dates

The provision applies to distributions after the date of enactment, December 22, 2017, and before January 1, 2026.

California Law (R&TC sections 17140 and 17140.4)

California conforms, under the PITL, to qualified tuition programs (also known as 529 accounts) under IRC section 529, as of the "specified date" of January 1, 2015,[180] with modifications, but does not conform to the rollover of 529 accounts to an ABLE account without penalty.

California conforms, under the PITL, relating to qualified ABLE programs and accounts under IRC section 529A, as of the "specified date" of January 1, 2015, with modifications, but does not conform to the rollover of 529 accounts to an ABLE account without penalty.

[176] For these purposes, a member of the family means, with respect to any designated beneficiary, the taxpayer's: (1) spouse; (2) child or descendant of a child; (3) brother, sister, stepbrother or stepsister; (4) father, mother or ancestor of either; (5) stepfather or stepmother; (6) niece or nephew; (7) aunt or uncle; (8) in-law; (9) the spouse of any individual described in (2)-(8); and (10) any first cousin of the designated beneficiary.
[177] 529A(b)(2)(B).
[178] 529(c)(3)(A).
[179] 529(c)(3)(A).
[180] R&TC section 17024.5.

Impact on California Revenue

Estimated Conformity Revenue Impact of Rollovers to ABLE Programs from 529 Programs For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	- $450,000	- $200,000	- $200,000

Section Section Title

11026 Treatment of Certain Individuals Performing Service in the Sinai Peninsula of Egypt

Background

Members of the Armed Forces serving in a combat zone are afforded a number of tax benefits. These include:

An exclusion from gross income of certain military pay received for any month during which the member served in a combat zone or was hospitalized as a result of serving in a combat zone;[181]

An exemption from taxes on death while serving in a combat zone or dying as a result of wounds, disease, or injury incurred while so serving;[182]

Special estate tax rules where death occurs in a combat zone;[183]

Special benefits to surviving spouses in the event of a service member's death or missing status;[184]

An extension of time limits governing the filing of returns and other rules regarding timely compliance with Federal income tax rules;[185] and

An exclusion from telephone excise taxes.[186]

New Federal Law (Uncodified Act Section 11026)

The provision grants combat zone tax benefits to the Sinai Peninsula of Egypt, if as of the date of enactment of the provision any member of the Armed Forces of the United States is entitled to special pay under section 310 of title 37, United States Code (relating to special pay; duty subject to hostile fire or imminent danger), for services performed in such location. This benefit lasts only during the period such entitlement is in effect but not later than taxable years beginning before January 1, 2026.

[181] IRC section 112; see also, IRC section 3401(a)(1), exempting such income from wage withholding.
[182] IRC section 692.
[183] IRC section 2201.
[184] IRC sections 2(a)(3) and 6013(f)(1).
[185] IRC section 7508.
[186] IRC section 4253(d).

Effective Dates

The applicable period of this provision is generally effective for that portion of the taxable year ending after June 9, 2015, which begins on such date and any subsequent taxable year beginning before January 1, 2026. The portion of the provision related to wage withholding applies to remuneration paid after the date of enactment, December 22, 2017, and any subsequent taxable year beginning before January 1, 2026.

California Law (R&TC sections 17142.5, 18571 and 19255)

California conforms to the federal rules that treat a qualified hazardous duty area as if it were a combat zone for purposes of applying IRC section 2(a)(3), relating to a special rule where a deceased spouse was in missing status; IRC section 112, relating to certain combat zone compensation of members of the Armed Forces; IRC section 692, relating to income taxes of Armed Forces members upon death; and IRC section 7508, relating to time for performing certain acts postponed by reason of service in combat zone,[187] [188] as of the "specified date" of January 1, 2015.[189] A qualified hazardous duty area is generally defined as Bosnia and Herzegovina, Croatia, or Macedonia if, as of March 20, 1996, any member of the Armed Forces of the U.S. is entitled to certain special pay provisions, relating to duty subject to hostile fire or imminent danger, for services performed in that country. However, California does not conform to the new federal provisions that similarly define the Sinai Peninsula of Egypt as a qualified hazardous duty area.

California also does not conform to the estate tax provision applicable to members of the Armed Forces dying in a combat zone or by reason of combat-zone-incurred wounds, etc., under IRC section 2201, nor to allowing a joint return where an individual is in missing status, under IRC section 6013(f)(1).

The FTB does not administer excise taxes similar to the taxation of phone service originating from a combat zone from members of the Armed Forces under IRC section 4253(d).

[187] R&TC section 18571.
[188] R&TC section 17140.5.
[189] R&TC section 17024.5.

Impact on California Revenue

Estimated Conformity Revenue Impact of Treatment of Certain individuals Performing Service in the Sinai Peninsula of Egypt For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
- $500,000	- $250,000	- $250,000	- $250,000

Section	Section Title
11027	Temporary Reduction in Medical Expense Deduction Floor

Background

For taxable years beginning after December 31, 2012, and ending before January 1, 2017, individuals could claim an itemized deduction for unreimbursed medical expenses, but only to the extent that such expenses exceed 10 percent of AGI.[190] For taxable years beginning before January 1, 2017, the 10-percent threshold was reduced to 7.5 percent in the case of taxpayers who have attained the age of 65 before the close of the taxable year. In the case of married taxpayers, the more favorable 7.5-percent threshold applies if either spouse has obtained the age of 65 before the close of the taxable year. For these taxpayers, during these years, in computing alternative minimum taxable income, the threshold is 10 percent for AMT purposes.

New Federal Law (Internal Revenue Code (IRC) sections 56 and 213)

The provision provides that, for taxable years beginning after December 31, 2016, and ending before January 1, 2019, the threshold for deducting medical expenses shall be 7.5 percent of AGI for all taxpayers. For these years, this threshold applies for purposes of the AMT in addition to the regular tax. For taxable years after January 1, 2019, the threshold for deducting medical expenses shall be 10 percent of AGI for all taxpayers.

Effective Dates

The provision is effective for taxable years beginning after December 31, 2016, and ending before January 1, 2019.

[190] IRC section 213. The threshold was amended by the Patient Protection and Affordable Care Act (Pubic Law Number 111-118). For taxable years beginning before January 1, 2013, the threshold was 7.5 percent and 10 percent for AMT purposes.

California Law (Revenue and Taxation Code (R&TC) sections 17062, 17062.3, 17062.5, 17201, and 17241)

California conforms, under the PITL, relating to the itemized deduction for unreimbursed medical expenses under IRC section 213, as of the "specified date" of January 1, 2015,[191] with modifications. California's modified conformity allows a deduction for the amount of medical expenses unreimbursed by insurance that exceed 7.5 percent of federal AGI.[192] As a result, the threshold percentage of unreimbursed medical expenses is the same for both federal and state purposes for the 2017 and 2018 tax years for purposes of the personal income tax. However, for taxable years beginning on or after January 1, 2019, the threshold for deducting unreimbursed medical expenses for federal and state taxes will differ – 10 percent of federal AGI for federal taxes and 7.5 percent of federal AGI for state income taxes.

Alternative Minimum Tax (AMT)

California conforms, under the PITL, relating to the AMT under IRC section 56, as of the "specified date" of January 1, 2015, with modifications.[193] However, California does not conform to the federal change to the AMT medical expense threshold from 10 percent to 7.5 percent of AGI. For California AMT purposes, the unreimbursed medical expense threshold remains 10 percent of federal AGI.[194]

Impact on California Revenue

Not applicable.

Section	Section Title
11028	Relief for 2016 Disaster Areas

Background

Distributions from Tax-Favored Retirement Plans

A distribution from a qualified retirement plan, a tax-sheltered annuity plan (a "section 403(b) plan"), an eligible deferred compensation plan of a State or local government employer (a "governmental section 457(b) plan"), or an individual retirement arrangement (an "IRA") generally is included in income for the year distributed.[195] These plans are referred to collectively as

[191] R&TC section 17024.5.
[192] R&TC sections 17241 and 17024.5(h)(2)(A).
[193] R&TC section 17062.
[194] IRC section 56(b)(1)(B).
[195] IRC sections 401(a), 403(a), 403(b), 457(b) and 408. Under section 3405, distributions from these plans are generally subject to income tax withholding unless the recipient elects otherwise. In addition, certain distributions

"eligible retirement plans." In addition, unless an exception applies, a distribution from a qualified retirement plan, a section 403(b) plan, or an IRA received before age $59^{1/2}$ is subject to a 10-percent additional tax (referred to as the "early withdrawal tax") on the amount includible in income.[196]

In general, a distribution from an eligible retirement plan may be rolled over to another eligible retirement plan within 60 days, in which case the amount rolled over generally is not includible in income. The IRS has the authority to waive the 60-day requirement if failure to waive the requirement would be against equity or good conscience, including cases of casualty, disaster or other events beyond the reasonable control of the individual.

The terms of a qualified retirement plan, section 403(b) plan, or governmental section 457(b) plan generally determine when distributions are permitted. However, in some cases, restrictions may apply to distribution before an employee's termination of employment, referred to as "in-service" distributions. Despite such restrictions, an in-service distribution may be permitted in the case of financial hardship or an unforeseeable emergency.

Tax-favored retirement plans are generally required to be operated in accordance with the terms of the plan document, and amendments to reflect changes to the plan generally must be adopted within a limited period.

Itemized Deduction for Casualty Losses

A taxpayer may generally claim a deduction for any loss sustained during the taxable year and not compensated by insurance or otherwise.[197] For individual taxpayers, deductible losses must be incurred in a trade or business or other profit-seeking activity or consist of property losses arising from fire, storm, shipwreck, or other casualty, or from theft. Personal casualty or theft losses are deductible only if they exceed $100 per casualty or theft. In addition, aggregate net casualty and theft losses are deductible only to the extent they exceed 10 percent of an individual taxpayer's adjusted gross income.

New Federal Law (Uncodified Act section 11028 affecting IRC sections 72, 165, 401, 403, 408, 408A, 414, 457, 3405, and 7701)

In General

The provision provides tax relief, as described below, relating to a "2016 disaster area," defined as any area with respect to which a major disaster was declared by the President under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act during calendar year 2016.

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from a qualified retirement plan, a section 403(b) plan, or a governmental section 457(b) plan are subject to mandatory income tax withholding at a 20-percent rate unless the distribution is rolled over.

[196] IRC section 72(t). Under present law, the 10-percent early withdrawal tax does not apply to distributions from a governmental section 457(b) plan.

[197] IRC section 165.

Distributions from Eligible Retirement Plans

Under the provision, an exception to the 10-percent early withdrawal tax applies in the case of a qualified 2016 disaster distribution from a qualified retirement plan, a section 403(b) plan or an IRA. In addition, as discussed further, income attributable to a qualified 2016 disaster distribution may be included in income ratably over three years, and the amount of a qualified 2016 disaster distribution may be recontributed to an eligible retirement plan within three years.

A qualified 2016 disaster distribution is a distribution from an eligible retirement plan made on or after January 1, 2016, and before January 1, 2018, to an individual whose principal place of abode at any time during calendar year 2016 was located in a 2016 disaster area and who has sustained an economic loss by reason of the events giving rise to the Presidential disaster declaration.

The total amount of distributions to an individual from all eligible retirement plans that may be treated as qualified 2016 disaster distributions is $100,000. Thus, any distributions in excess of $100,000 during the applicable period are not qualified 2016 disaster distributions.

Any amount required to be included in income as a result of a qualified 2016 disaster is included in income ratably over the three-year period beginning with the year of distribution unless the individual elects not to have ratable inclusion apply.

Any portion of a qualified 2016 disaster distribution may, at any time during the three-year period beginning the day after the date on which the distribution was received, be recontributed to an eligible retirement plan to which a rollover can be made. Any amount recontributed within the three-year period is treated as a rollover and thus is not includible in income. For example, if an individual receives a qualified 2016 disaster distribution in 2016, that amount is included in income, generally ratably over the year of the distribution and the following two years, but is not subject to the 10-percent early withdrawal tax. If, in 2018, the amount of the qualified 2016 disaster distribution is recontributed to an eligible retirement plan, the individual may file an amended return to claim a refund of the tax attributable to the amount previously included in income. In addition, if, under the ratable inclusion provision, a portion of the distribution has not yet been included in income at the time of the contribution, the remaining amount is not includible in income.

A qualified 2016 disaster distribution is a permissible distribution from a qualified retirement plan, section 403(b) plan, or governmental section 457(b) plan, regardless of whether a distribution otherwise would be permissible.[198] A plan is not treated as violating any IRC requirement merely because it treats a distribution as a qualified 2016 disaster distribution, provided that the aggregate amount of such distributions from plans maintained by the employer and members of the employer's controlled group or affiliated service group does not exceed $100,000. Thus, a plan is not treated as violating any IRC requirement merely because an

[198] A qualified 2016 disaster distributions is subject to income tax withholding unless the recipient elects otherwise. Mandatory 20-percent withholding does not apply.

individual might receive total distributions in excess of $100,000, taking into account distributions from plans of other employers or IRAs.

A plan amendment made pursuant to the provision (or a regulation issued thereunder) may be retroactively effective if, in addition to the requirements described below, the amendment is made on or before the last day of the first plan year beginning after December 31, 2018, (or in the case of a governmental plan, December 31, 2020), or a later date prescribed by the Secretary. In addition, the plan will be treated as operated in accordance with plan terms during the period beginning with the date the provision or regulation takes effect (or the date specified by the plan if the amendment is not required by the provision or regulation) and ending on the last permissible date for the amendment (or, if earlier, the date the amendment is adopted). In order for an amendment to be retroactively effective, it must apply retroactively for that period, and the plan must be operated in accordance with the amendment during that period.

Modification of Rules Related to Casualty Losses

Under the provision, in the case of a net disaster loss which arose on or after January 1, 2016, and before January 1, 2018, in a 2016 disaster area and was attributable to the events giving rise to the Presidential disaster declaration, such losses are deductible without regard to whether aggregate net losses exceed 10 percent of a taxpayer's adjusted gross income. Under the provision, in order to be deductible, the losses must exceed $500 per casualty. Additionally, such losses may be claimed in addition to the standard deduction.

Effective Dates

The provision related to qualified 2016 disaster distributions is effective on the date of enactment, December 22, 2017, but only applies to qualified 2016 disaster distributions made on or after January 1, 2016, and before January 1, 2018. The provision related to net disaster losses is effective the date of enactment, December 22, 2017, but is applicable for any taxable year beginning after December 31, 2015, and before January 1, 2018.

California Law (R&TC sections 17081, 17085, 17501, and 17551)

California automatically conforms to the federal changes with respect to qualified 2016 disaster distributions and re-contributions from eligible retirement plans.[199],[200]

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[199] Under R&TC section 17501, California conforms by reference to Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, including Part I (IRC sections 401 to 420, relating to pension, profit-sharing, stock bonus plans, etc.), as of R&TC section 17024.5's "specified date" of January 1, 2015. However, except for increases in the maximum amount of elective deferrals that may be excluded from income under IRC section 402(g), R&TC section 17501(b) specifically provides that federal changes to Part I of Subchapter D of Chapter 1 of Subtitle A of the IRC automatically apply without regard to taxable year to the same extent as applicable for federal income tax purposes (and thus California adopts all changes made to those IRC sections without regard to the "specified date" contained in R&TC section 17024.5).

[200] Under R&TC section 17551, California conforms by reference to Subchapter E of Chapter 1 of Subtitle A of the IRC, relating to accounting periods and methods of accounting, as of R&TC section 17024.5's "specified date" of January 1, 2015. However, R&TC 17551(c) specifically provides that federal changes to IRC section 457, relating to deferred compensation plans of state and local governments and tax-exempt entities, automatically apply without

California also automatically conforms to federal changes made to the additional tax on early distributions from qualified retirement plans, modified to provide that the California early-distribution tax is 2.5 percent of the amount includible in income rather than the federal rate of 10 percent.[201]

California withholding on eligible rollover distributions is 10 percent of the federal withholding amount.[202] However, because qualified 2016 disaster distributions are not eligible rollover distributions under this provision, California withholding does not apply.

California conforms by reference to IRC section 165, relating to losses, as of the "specified date" of January 1, 2015,[203] but does not conform to the federal changes that apply to a net disaster loss that occurs in a 2016 disaster area.

Impact on California Revenue

Baseline.

Part IV—Education

Section	Section Title
11031	Treatment of Student Loans Discharged On Account of Death or Disability

Background

Gross income generally includes the discharge of indebtedness of the taxpayer. Under an exception to this general rule, gross income does not include any amount from the forgiveness (in whole or in part) of certain student loans, provided that the forgiveness is contingent on the student's working for a certain period of time in certain professions for any of a broad class of employers.[204]

Student loans eligible for this special rule must be made to an individual to assist the individual in attending an educational institution that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its education activities are regularly carried on. Loan proceeds may be used not only for tuition and required fees, but also to cover room and board expenses. The loan must be made by (1) the United States (or an instrumentality or agency thereof), (2) a State (or any political subdivision thereof),

regard to taxable year to the same extent applicable for federal income taxes purposes (and thus California adopts all changes made to that IRC section without regard to the "specified date" contained in R&TC section 17024.5).

[201] R&TC section 17085(c).

[202] Unemployment Insurance Code (UIC) section 13028(c)(3).

[203] R&TC section 17024.5.

[204] IRC section 108(f).

(3) certain tax-exempt public benefit corporations that control a State, county, or municipal hospital and whose employees have been deemed to be public employees under State law, or (4) an educational organization that originally received the funds from which the loan was made from the United States, a State, or a tax-exempt public benefit corporation.

In addition, an individual's gross income does not include amounts from the forgiveness of loans made by educational organizations (and certain tax-exempt organizations in the case of refinancing loans) out of private, nongovernmental funds if the proceeds of such loans are used to pay costs of attendance at an educational institution or to refinance any outstanding student loans (not just loans made by educational organizations) and the student is not employed by the lender organization. In the case of such loans made or refinanced by educational organizations (or refinancing loans made by certain tax-exempt organizations), cancellation of the student loan must be contingent on the student working in an occupation or area with unmet needs and such work must be performed for, or under the direction of, a tax-exempt charitable organization or a governmental entity.

Finally, an individual's gross income does not include any loan repayment amount received under the National Health Service Corps loan repayment program, certain State loan repayment programs, or any amount received by an individual under any State loan repayment or loan forgiveness program that is intended to provide for the increased availability of health care services in underserved or health professional shortage areas (as determined by the State).

<u>New Federal Law (IRC section 108)</u>

The provision modifies the exclusion of student loan discharges from gross income, by including within the exclusion certain discharges on account of death or disability. Loans eligible for the exclusion under the provision are loans made by (1) the United States (or an instrumentality or agency thereof), (2) a State (or any political subdivision thereof), (3) certain tax-exempt public benefit corporations that control a State, county, or municipal hospital and whose employees have been deemed to be public employees under State law, (4) an educational organization that originally received the funds from which the loan was made from the United States, a State, or a tax-exempt public benefit corporation, or (5) private education loans (for this purpose, private education loan is defined in section 140(7) of the Consumer Protection Act).[205]

Under the provision, the discharge of a loan as described above is excluded from gross income if the discharge was pursuant to the death or total and permanent disability of the student.[206]

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[205] 15 U.S.C. 1650(7).

[206] Although the provision makes specific reference to those provisions of the Higher Education Act of 1965 that discharge William D. Ford Federal Direct Loan Program loans, Federal Family Education Loan Program loans, and Federal Perkins Loan Program loans in the case of death and total and permanent disability, the provision also contains a catch-all exclusion in the case of a student loan discharged on account of the death or total and permanent disability of the student, in addition to those specific statutory references.

Effective Dates

The provision is effective for discharges of indebtedness after December 31, 2017, and before January 1, 2026.

California Law (R&TC sections 17131, 17132.11, 17134, and 17144.7)

California generally conforms, under the PITL, to the federal income tax rules relating to the cancellation of student loans under IRC section 108, as of the specified date of January 1, 2015,[207] with modifications, but does not conform to the exclusion from gross income for student loan discharges due to the death or disability of the debtor.

In addition, the state has the following stand-alone provisions for which no similar federal provisions exist.

California allows an exclusion from gross income for student loan debt that is cancelled or repaid under the income-based repayment programs administered by the U.S. Department of Education.[208] This exclusion applies to discharges of indebtedness occurring on or after January 1, 2014. Additionally, for taxable years beginning on or after January 1, 2017, and before January 1, 2022, California allows an exclusion from gross income for student loan debt that is cancelled or repaid under the Income Contingent Repayment plan, the Pay As You Earn Repayment plan, and the Revised Pay As You Earn Repayment plan, as administered by the U.S. Department of Education.[209] [210]

For discharges of indebtedness occurring on or after January 1, 2015, and before January 1, 2020, existing state law excludes from an eligible individual's gross income any amounts that would otherwise result from a student loan forgiven as a result of the closure of Corinthian Colleges and similar closures.[211]

Impact on California Revenue

Estimated Conformity Revenue Impact of Treatment of Student Loans Discharged On Account of Death or Disability For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	- $1,000,000	- $500,000	- $500,000

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[207] R&TC section 17024.5.
[208] R&TC section 17132.11.
[209] Repayment plans repaid or cancelled as authorized under Title 20, U.S.C., section 1087e(e).
[210] AB 461 (Muratsuchi, Chapter 525, Statutes of 2017).
[211] R&TC section 17144.7.

Section	Section Title
11032	529 Account Funding For Elementary and Secondary Education

Background

Coverdell Education Savings Accounts

A Coverdell education savings account is a trust or custodial account created exclusively for the purpose of paying qualified education expenses of a named beneficiary.[212] Annual contributions to Coverdell education savings accounts may not exceed $2,000 per designated beneficiary and may not be made after the designated beneficiary reaches age 18 (except in the case of a special needs beneficiary). The contribution limit is phased out for taxpayers with modified AGI between $95,000 and $110,000 ($190,000 and $220,000 for married taxpayers filing a joint return); the AGI of the contributor, and not that of the beneficiary, controls whether a contribution is permitted by the taxpayer.

Earnings on contributions to a Coverdell education savings account generally are subject to tax when withdrawn.[213] However, distributions from a Coverdell education savings account are excludable from the gross income of the distributee (*i.e.,* the student) to the extent that the distribution does not exceed the qualified education expenses incurred by the beneficiary during the year the distribution is made. The earnings portion of a Coverdell education savings account distribution not used to pay qualified education expenses is includible in the gross income of the distributee and generally is subject to an additional 10-percent tax.[214]

Tax-free (and free of additional 10-percent tax) transfers or rollovers of account balances from one Coverdell education savings account benefiting one beneficiary to another Coverdell education savings account benefiting another beneficiary (as well as redesignations of the named beneficiary) are permitted, provided that the new beneficiary is a member of the family of the prior beneficiary and is under age 30 (except in the case of a special needs beneficiary). In general, any balance remaining in a Coverdell education savings account is deemed to be distributed within 30 days after the date that the beneficiary reaches age 30 (or, if the beneficiary dies before attaining age 30, within 30 days of the date that the beneficiary dies).

Qualified education expenses include qualified elementary and secondary expenses and qualified higher education expenses. Such qualified education expenses generally include only out-of-pocket expenses. They do not include expenses covered by employer-provided educational assistance or scholarships for the benefit of the beneficiary that are excludable from gross income.

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[212] IRC section 530.
[213] In addition, Coverdell education savings accounts are subject to the unrelated business income tax imposed by IRC section 511.
[214] This 10-percent additional tax does not apply if a distribution from an education savings account is made on account of the death or disability of the designated beneficiary, or if made on account of a scholarship received by the designated beneficiary.

The term qualified elementary and secondary school expenses means expenses for: (1) tuition, fees, academic tutoring, special needs services, books, supplies, and other equipment incurred in connection with the enrollment or attendance of the beneficiary at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12) as determined under State law; (2) room and board, uniforms, transportation, and supplementary items or services (including extended day programs) required or provided by such a school in connection with such enrollment or attendance of the beneficiary; and (3) the purchase of any computer technology or equipment (as defined in IRC section 170(e)(6)(F)(i)) or internet access and related services, if such technology, equipment, or services are to be used by the beneficiary and the beneficiary's family during any of the years the beneficiary is in elementary or secondary school. Computer software primarily involving sports, games, or hobbies is not considered a qualified elementary and secondary school expense unless the software is predominantly educational in nature.

The term qualified higher education expenses includes tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an eligible education institution, regardless of whether the beneficiary is enrolled at an eligible educational institution on a full-time, half-time, or less than half-time basis.[215] Moreover, qualified higher education expenses include certain room and board expenses for any period during which the beneficiary is at least a half-time student. Qualified higher education expenses include expenses with respect to undergraduate or graduate-level courses. In addition, qualified higher education expenses include amounts paid or incurred to purchase tuition credits (or to make contributions to an account) under a qualified tuition program for the benefit of the beneficiary of the Coverdell education savings account.[216]

IRC Section 529 Qualified Tuition Programs

In General

A qualified tuition program is a program established and maintained by a State or agency or instrumentality thereof, or by one or more eligible educational institutions, which satisfies certain requirements and under which a person may purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary (a "prepaid tuition program"). IRC section 529 provides specified income tax and transfer tax rules for the treatment of accounts and contracts established under qualified tuition programs.[217] In the case of a program established and maintained by a State or agency or instrumentality thereof, a qualified tuition program also includes a program under which a person may make contributions to an account that is established for the purpose of satisfying the qualified higher education expenses of the designated beneficiary of the account, provided it satisfies certain specified requirements (a "savings account program"). Under both types of qualified tuition programs, a contributor

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[215] Qualified higher education expenses are defined in the same manner as for qualified tuition programs.
[216] IRC section 530(b)(2)(B).
[217] For purposes of this description, the term "account" is used interchangeably to refer to a prepaid tuition benefit contract or a tuition savings account established pursuant to a qualified tuition program.

establishes an account for the benefit of a particular designated beneficiary to provide for that beneficiary's higher education expenses.

In general, prepaid tuition contracts and tuition savings accounts established under a qualified tuition program involve prepayments or contributions made by one or more individuals for the benefit of a designated beneficiary. Decisions with respect to the contract or account are typically made by an individual who is not the designated beneficiary. Qualified tuition accounts or contracts generally require the designation of a person (generally referred to as an "account owner")[218] whom the program administrator (oftentimes a third party administrator retained by the State or by the educational institution that established the program) may look to for decisions, recordkeeping, and reporting with respect to the account established for a designated beneficiary. The person or persons who make the contributions to the account need not be the same person who is regarded as the account owner for purposes of administering the account. Under many qualified tuition programs, the account owner generally has control over the account or contract, including the ability to change designated beneficiaries and to withdraw funds at any time and for any purpose. Thus, in practice, qualified tuition accounts or contracts generally involve a contributor, a designated beneficiary, an account owner (who often times is not the contributor or the designated beneficiary), and an administrator of the account or contract.

Qualified Higher Education Expenses

For purposes of receiving a distribution from a qualified tuition program that qualifies for favorable tax treatment under the IRC, qualified higher education expenses means tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution, and expenses for special needs services in the case of a special needs beneficiary that are incurred in connection with such enrollment or attendance. Qualified higher education expenses generally also include room and board for students who are enrolled at least halftime. Qualified higher education expenses include the purchase of any computer technology or equipment, or Internet access or related services, if such technology or services were to be used primarily by the beneficiary during any of the years a beneficiary is enrolled at an eligible institution.

Contributions to Qualified Tuition Programs

Contributions to a qualified tuition program must be made in cash. IRC section 529 does not impose a specific dollar limit on the amount of contributions, account balances, or prepaid tuition benefits relating to a qualified tuition account; however, the program is required to have adequate safeguards to prevent contributions in excess of amounts necessary to provide for the beneficiary's qualified higher education expenses. Contributions generally are treated as a completed gift eligible for the gift tax annual exclusion. Contributions are not tax deductible for Federal income tax purposes, although they may be deductible for State income tax purposes. Amounts in the account accumulate on a tax-free basis (*i.e.,* income on accounts in the plan is not subject to current income tax).

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[218] IRC section 529 refers to contributors and designated beneficiaries, but does not define or otherwise refer to the term ''account owner," which is a commonly used term among qualified tuition programs.

A qualified tuition program may not permit any contributor to, or designated beneficiary under, the program to direct (directly or indirectly) the investment of any contributions (or earnings thereon) more than two times in any calendar year, and must provide separate accounting for each designated beneficiary. A qualified tuition program may not allow any interest in an account or contract (or any portion thereof) to be used as security for a loan.

New Federal Law (IRC section 529)

The provision modifies IRC section 529 plans to allow such plans to distribute not more than $10,000 in expenses for tuition incurred during the taxable year in connection with the enrollment or attendance of the designated beneficiary at a public, private or religious elementary or secondary school. This limitation applies on a per-student basis, rather than a per-account basis. Thus, under the provision, although an individual may be the designated beneficiary of multiple accounts, that individual may receive a maximum of $10,000 during a taxable year in distributions free of tax, regardless of whether the funds are distributed from multiple accounts. Any excess distributions received by the individual would be treated as a distribution subject to tax under the general rules of IRC section 529.

Effective Dates

The provision applies to distributions made after December 31, 2017.

California Law (R&TC section 17140, 17140.3, 23711, 23711.5, and 24306)

California law, under the PITL and the CTL, conforms relating to qualified tuition programs under IRC section 529, as of the “specified date” of January 1, 2015,[219] but does not conform to IRC section 529 account funding for elementary and secondary education or to the new federal rules relating to the maximum distribution amount.

Impact on California Revenue

Estimated Conformity Revenue Impact of 529 Account Funding For Elementary and Secondary Education For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	- $1,700,000	- $900,000	- $900,000

[219] R&TC sections 17024.5 and 23051.5.

Part V—Deductions and Exclusions

Section	Section Title
11041	Suspension of Deduction for Personal Exemptions

Background

Under present law, in determining taxable income, an individual reduces AGI by any personal exemption deductions and either the applicable standard deduction or his or her itemized deductions. Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. For 2017, the amount deductible for each personal exemption is $4,050. This amount is indexed annually for inflation. The personal exemption amount is phased out in the case of an individual with AGI in excess of $313,800 for taxpayers filing jointly, $287,650 for heads of household and $261,500 for all other filers. In addition, no personal exemption is allowed in the case of a dependent if a deduction is allowed to another taxpayer.

Withholding Rules

Under present law, the amount of tax required to be withheld by employers from a taxpayer's wages is based in part on the number of withholding exemptions a taxpayer claims on his Form W-4. An employee is entitled to the following exemptions: (1) an exemption for himself, unless he allowed to be claimed as a dependent of another person; (2) an exemption to which the employee's spouse would be entitled, if that spouse does not file a Form W-4 for that taxable year claiming an exemption described in (1); (3) an exemption for each individual who is a dependent (but only if the employee's spouse has not also claimed such a withholding exemption on a Form W-4); (4) additional withholding allowances (taking into account estimated itemized deductions, estimated tax credits, and additional deductions as provided by the Secretary of the Treasury); and (5) a standard deduction allowance.

Filing Requirements

Under present law, an unmarried individual is required to file a tax return for the taxable year if in that year the individual had income which equals or exceeds the exemption amount plus the standard deduction applicable to such individual (*i.e.*, single, head of household, or surviving spouse). An individual entitled to file a joint return is required to do so unless that individual's gross income, when combined with the individual's spouse's gross income for the taxable year, is less than the sum of twice the exemption amount plus the basic standard deduction applicable to a joint return, provided that such individual and his spouse, at the close of the taxable year, had the same household as their home.

Trusts and Estates

In lieu of the deduction for personal exemptions, an estate is allowed a deduction of $600. A trust is allowed a deduction of $100; $300 if required to distribute all its income currently; and an amount equal to the personal exemption of an individual in the case of a qualified disability trust.

<u>New Federal Law (IRC sections 151, 642, 3402, 6012, and 6334)</u>

The provision repeals the deduction for personal exemptions.

The provision modifies the requirements for those who are required to file a tax return. In the case of an individual who is not married, such individual is required to file a tax return if the taxpayer's gross income for the taxable year exceeds the applicable standard deduction. Married individuals are required to file a return if that individual's gross income, when combined with the individual's spouse's gross income for the taxable year, is more than the standard deduction applicable to a joint return, provided that: (i) such individual and his spouse, at the close of the taxable year, had the same household as their home; (ii) the individual's spouse does not make a separate return; and (iii) neither the individual nor his spouse is a dependent of another taxpayer who has income (other than earned income) in excess of $500 (indexed for inflation).

The provision repeals the enhanced deduction for qualified disability trusts.

The provision provides that the Secretary of the Treasury shall develop rules to determine the amount of tax required to be withheld by employers from a taxpayer's wages.

<u>Effective Dates</u>

The provision is effective for taxable years beginning after December 31, 2017, and before January 1, 2026.

California Law (R&TC sections 17054, 17054.1, 17732, 18551, and 18667)

California does not conform to federal personal-exemption deductions. Instead of personal-exemption deductions, the PITL provides personal-exemption tax credits.[220] For taxable year 2017, individual taxpayers are allowed personal-exemption tax credits in the amounts shown below:

Exemption Type	Number of Exemptions	Exemption Amount
Personal Exemption	One exemption for themselves, and one for a spouse, if married filing joint (MFJ).	$114
Senior	One additional exemption if 65 or older, and one for a spouse 65 or older, if MFJ.	$114
Blind	One additional exemption if visually impaired and one for a visually impaired spouse.	$114
Dependent	One exemption for each qualifying dependent.	$353

The personal-exemption tax credits are reduced when a taxpayer's federal AGI exceeds a threshold amount.[221] For taxable year 2017, the exemption credits are reduced by $6 ($12 if married filing joint) for each $2,500 ($1,250 if married filing separately) of AGI or fraction thereof, that exceeds the following threshold amounts:

Single or Married/RDP filing separate — $187,203

Married/RDP filing joint — $280,808

Head of Household — $374,411

Impact on California Revenue

Not applicable.

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[220] R&TC section 17054. The exemption credits are adjusted annually based on the California Consumer Price Index.
[221] R&TC section 17054.1. The phase-out thresholds are adjusted annually based on the California Consumer Price Index.

Section	Section Title
11042	Limitation on Deduction for State and Local, Etc., Taxes

Background

Individuals are permitted a deduction for certain taxes paid or accrued, whether or not incurred in a taxpayer's trade or business. These taxes are: (i) State and local real and foreign property taxes;[222] (ii) State and local personal property taxes;[223] and (iii) State, local, and foreign income, war profits, and excess profits taxes.[224] At the election of the taxpayer, an itemized deduction may be taken for State and local general sales taxes in lieu of the itemized deduction for State and local income taxes.[225]

Property taxes may be allowed as a deduction in computing AGI if incurred in connection with property used in a trade or business; otherwise they are an itemized deduction. In the case of State and local income taxes, the deduction is an itemized deduction notwithstanding that the tax may be imposed on profits from a trade or business.[226]

Individuals also are permitted a deduction for Federal and State generation skipping transfer (GST) tax imposed on certain income distributions that are included in the gross income of the distributee.[227]

In determining a taxpayer's alternative minimum taxable income, no itemized deduction for property, income, or sales tax is allowed.

New Federal Law (IRC section 164)

This provision provides that an individual may claim an itemized deduction of up to $10,000 ($5,000 for married taxpayers filing a separate return) for the aggregate of (i) state and local property taxes not accrued in carrying on a trade or business, or an activity described in section 212, and (ii) state and local income, foreign, income, war profits, and excess profits taxes (or sales taxes in lieu of income, etc. taxes) paid or accrued in the taxable year. Individuals are also not allowed a deduction for foreign real property taxes. The above rules apply to taxable years beginning after December 31, 2017, and beginning before January 1, 2026.

The limitations above do not apply to state and local property taxes, state and local personal property taxes, foreign property taxes, or sales taxes paid or accrued in the taxable year if paid or accrued in carrying on a trade or business or an activity described in IRC section 212. For

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[222] IRC section 164(a)(1).
[223] IRC section 164(a)(2).
[224] IRC section 164(a)(3). A foreign tax credit, in lieu of a deduction, is allowable for foreign taxes if the taxpayer so elects.
[225] IRC section 164(b)(5).
[226] See H. Rep. No. 1365 to accompany Individual Income Tax Bill of 1944 (78th Congress, 2nd Session), reprinted at 19 Cumulative Bulletin 839 (1944)).
[227] IRC section 164(a)(4).

instance, in the case of property taxes, an individual may deduct such items in full only if these taxes were imposed on business assets (such as residential rental property).

The provision also provides that, in the case of an amount paid in a taxable year beginning before January 1, 2018, with respect to a state or local income tax imposed for a taxable year beginning after December 31, 2017, the payment shall be treated as paid on the last day of the taxable year for which such tax is so imposed for purposes of applying the provision limiting the dollar amount of the deduction. Thus, under the provision, an individual may not claim an itemized deduction for the 2017 tax year on a prepayment of income tax for a future taxable year in order to avoid the dollar limitation applicable for taxable years beginning after 2017.

Effective Dates

The provision is applicable to the limitation on deduction for state and local income taxes for taxable years beginning after December 31, 2017, and before January 1, 2026. The provision related to treatment of amounts paid is effective for taxable years beginning on or after December 31, 2016.

California Law (R&TC sections 17201 and 17220)

California conforms, under the PITL, relating to the deductibility of taxes under IRC section 164, as of the "specified date" of January 1, 2015, with modifications.[228] However, California does not allow a deduction for state and local, foreign, income, war profits, and excess profits taxes or the election to deduct sales taxes. California conforms, under the PITL, to the other provisions related to deductibility of taxes under IRC section 164, as of the "specified date" of January 1, 2015,[229] with modifications.

Impact on California Revenue

Estimated Conformity Revenue Impact of Limitation on Deduction for State and Local, Etc. Taxes For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	$550,000,000	$350,000,000	$360,000,000

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228 R&TC section 17062.
229 R&TC section 17024.5.

Section	Section Title
11043	Limitation on Deduction for Qualified Residence Interest

Background

As a general matter, personal interest is not deductible.[230] Qualified residence interest is not treated as personal interest and is allowed as an itemized deduction, subject to limitations.[231] Qualified residence interest means interest paid or accrued during the taxable year on either acquisition indebtedness or home equity indebtedness. A qualified residence means the taxpayer's principal residence and one other residence of the taxpayer selected to be a qualified residence. A qualified residence can be a house, condominium, cooperative, mobile home, house trailer, or boat.

Acquisition Indebtedness

Acquisition indebtedness is indebtedness that is incurred in acquiring, constructing, or substantially improving a qualified residence of the taxpayer and which secures the residence. The maximum amount treated as acquisition indebtedness is $1 million ($500,000 in the case of a married person filing a separate return).

Acquisition indebtedness also includes indebtedness from the refinancing of other acquisition indebtedness, but only to the extent of the amount (and term) of the refinanced indebtedness. Thus, for example, if the taxpayer incurs $200,000 of acquisition indebtedness to acquire a principal residence and pays down the debt to $150,000, the taxpayer's acquisition indebtedness with respect to the residence cannot thereafter be increased above $150,000 (except by indebtedness incurred to substantially improve the residence).

Interest on acquisition indebtedness is allowable in computing alternative minimum taxable income. However, in the case of a second residence, the acquisition indebtedness may only be incurred with respect to a house, apartment, condominium, or a mobile home that is not used on a transient basis.

Home Equity Indebtedness

Home equity indebtedness is indebtedness (other than acquisition indebtedness) secured by a qualified residence.

The amount of home equity indebtedness may not exceed $100,000 ($50,000 in the case of a married individual filing a separate return) and may not exceed the fair market value of the residence reduced by the acquisition indebtedness.

Interest on home equity indebtedness is not deductible in computing alternative minimum taxable income.

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[230] IRC section 163(h)(1).
[231] IRC sections 163(h)(2)(D) and (h)(3).

Interest on qualifying home equity indebtedness is deductible, regardless of how the proceeds of the indebtedness are used. For example, personal expenditures may include health costs and education expenses for the taxpayer's family members or any other personal expenses such as vacations, furniture, or automobiles. A taxpayer and a mortgage company can contract for the home equity indebtedness loan proceeds to be transferred to the taxpayer in a lump sum payment (*e.g.*, a traditional mortgage), a series of payments (*e.g.*, a reverse mortgage), or the lender may extend the borrower a line of credit up to a fixed limit over the term of the loan (*e.g.*, a home equity line of credit).

Thus, the aggregate limitation on the total amount of a taxpayer's acquisition indebtedness and home equity indebtedness with respect to a taxpayer's principal residence and a second residence that may give rise to deductible interest is $1,100,000 ($550,000 for married persons filing a separate return).

<u>New Federal Law (IRC section 163)</u>

The provision specifies that, in the case of taxable years beginning after December 31, 2017, and beginning before January 1, 2026, a taxpayer may treat no more than $750,000 as acquisition indebtedness ($375,000 in the case of married taxpayers filing separately). In the case of acquisition indebtedness incurred before December 15, 2017,[232] this limitation is $1,000,000 ($500,000 in the case of married taxpayers filing separately).[233] For taxable years beginning after December 31, 2025, a taxpayer may treat up to $1,000,000 ($500,000 in the case of married taxpayers filing separately) of indebtedness as acquisition indebtedness, regardless of when the indebtedness was incurred.

Additionally, the provision suspends the deduction for interest on home equity indebtedness. Thus, for taxable years beginning after December 31, 2017, a taxpayer may not claim a deduction for interest on home equity indebtedness. The suspension ends for taxable years beginning after December 31, 2025.

<u>Effective Dates</u>

The provision is effective for taxable years beginning after December 31, 2017, and before January 1, 2026.

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[232] The provision specifies that a taxpayer who has entered into a binding written contract before December 15, 2017, to close on the purchase of a principal residence before January 1, 2018, and who purchases such residence before April 1, 2018, shall be considered to incurred acquisition indebtedness prior to December 15, 2017.

[233] Special rules apply in the case of indebtedness from refinancing existing acquisition indebtedness. Specifically, the $1,000,000 ($500,000 in the case of married taxpayers filing separately) limitation continues to apply to any indebtedness incurred on or after December 15, 2017, to refinance qualified residence indebtedness incurred before that date to the extent the amount of the indebtedness resulting from the refinancing does not exceed the amount of the refinanced indebtedness. Thus, the maximum dollar amount that may be treated as principal residence acquisition indebtedness will not decrease by reason of a refinancing.

California Law (R&TC section 17201 and 17225)

California conforms, under the PITL, to the federal rules relating to the deduction for qualified principal residence interest under IRC section 163 as of the "specified date" of January 1, 2015,[234] with modifications, but does not conform to the new federal limitations on the deduction for qualified residence interest.

Impact on California Revenue

Estimated Conformity Revenue Impact of Limitation on Deduction for Qualified Residence Interest Background For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	$800,000,000	$550,000,000	$600,000,000

Section	Section Title
11044	Modification of Deduction for Personal Casualty Losses

Background

A taxpayer may generally claim a deduction for any loss sustained during the taxable year, not compensated by insurance or otherwise. For individual taxpayers, deductible losses must be incurred in a trade or business or other profit-seeking activity or consist of property losses arising from fire, storm, shipwreck, or other casualty, or from theft.[235] Personal casualty or theft losses are deductible only if they exceed $100 per casualty or theft. In addition, aggregate net casualty and theft losses are deductible only to the extent they exceed 10 percent of an individual taxpayer's adjusted gross income.

New Federal Law (IRC section 165)

The provision temporarily modifies the deduction for personal casualty and theft losses. Under the provision, a taxpayer may claim a personal casualty loss (subject to the limitations described above) only if such loss was attributable to a disaster declared by the President under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act.

[234] R&TC section 17024.5.
[235] IRC section 165(c).

Effective Dates

The provision is effective for losses incurred in taxable years beginning after December 31, 2017, and before January 1, 2026.

California Law (R&TC sections 17201, 17207, and 17207.14)

California conforms, under the PITL, relating to the treatment of personal casualty loss deductions under IRC section 165(h), as of the "specified date" of January 1, 2015, with modifications,[236] but does not conform to the temporary federal modification to only allow a deduction for presidentially declared disasters as personal casualty losses.

California tax law identifies specific events as disasters and excess disaster losses are allowed special carry forward treatment. That is, 100 percent of the excess disaster loss may be carried over for up to 15 taxable years. In addition, IRC section 165(i), relating to the election to take a loss deduction in the preceding year, applies to disasters that were the subject of a Governor's proclamation, but not the subject of a Presidential disaster declaration.[237]

Impact on California Revenue

Estimated Conformity Revenue Impact of Modification of Deduction For Personal Casualty Losses For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	$25,000,000	$16,000,000	$17,000,000

Section	Section Title
11045	Suspension of Miscellaneous Itemized Deductions

Background

Individuals may claim itemized deductions for certain miscellaneous expenses. Certain of these expenses are not deductible unless, in aggregate, they exceed two percent of the taxpayer's adjusted gross income ("AGI").[238] The deductions described below are subject to the aggregate two-percent floor.[239]

[236] R&TC section 17024.5.
[237] R&TC section 17207.14.
[238] IRC section 67(a).
[239] The miscellaneous itemized deduction for tax preparation expenses is described in a separate section of this document.

Expenses for the Production or Collection of Income

Individuals may deduct all ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income.[240] Present law and IRS guidance provide examples of items that may be deducted under this provision. This non-exhaustive list includes: [241]

Appraisal fees for a casualty loss or charitable contribution;

Casualty and theft losses from property used in performing services as an employee;

Clerical help and office rent in caring for investments;

Depreciation on home computers used for investments;

Excess deductions (including administrative expenses) allowed a beneficiary on termination of an estate or trust;

Fees to collect interest and dividends;

Hobby expenses, but generally not more than hobby income;

Indirect miscellaneous deductions from pass-through entities;

Investment fees and expenses;

Loss on deposits in an insolvent or bankrupt financial institution:

Loss on traditional IRAs or Roth IRAs, when all amounts have been distributed;

Repayments of income;

Safe deposit box rental fees, except for storing jewelry and other personal effects;

Service charges on dividend reinvestment plans; and

Trustee's fees for an IRA, if separately billed and paid.

Tax Preparation Expenses

For regular income tax purposes, individuals are allowed an itemized deduction for expenses for the production of income. These expenses are defined as ordinary and necessary expenses paid or incurred in a taxable year: (1) for the production or collection of income; (2) for the management, conservation, or maintenance of property held for the production of income; or (3) in connection with the determination, collection, or refund of any tax.[242]

Unreimbursed Expenses Attributable to the Trade or Business of Being an Employee

In general, unreimbursed business expenses incurred by an employee are deductible, but only as an itemized deduction and only to the extent the expenses exceed two percent of adjusted gross income.[243] Present law and IRS guidance provide examples of items that may be deducted under this provision. This non-exhaustive list includes:[244]

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[240] IRC section 212(1).
[241] See IRS Publication 529, *''Miscellaneous Deductions''* (2016), p. 9.
[242] IRC section 212.
[243] IRC sections 62(a)(1) and 67.
[244] See IRS Publication 529, *"Miscellaneous Deductions"* (2016), p. 3.

Business bad debt of an employee;

Business liability insurance premiums;

Damages paid to a former employer for breach of an employment contract;

Depreciation on a computer a taxpayer's employer requires him to use in his work;

Dues to a chamber of commerce if membership helps the taxpayer perform his job;

Dues to professional societies;

Educator expenses;[245]

Home office or part of a taxpayer's home used regularly and exclusively in the taxpayer's work;

Job search expenses in the taxpayer's present occupation;

Laboratory breakage fees;

Legal fees related to the taxpayer's job;

Licenses and regulatory fees;

Malpractice insurance premiums;

Medical examinations required by an employer;

Occupational taxes;

Passport fees for a business trip;

Repayment of an income aid payment received under an employer's plan;

Research expenses of a college professor;

Rural mail carriers' vehicle expenses;

Subscriptions to professional journals and trade magazines related to the taxpayer's work;

Tools and supplies used in the taxpayer's work;

Purchase of travel, transportation, meals, entertainment, gifts, and local lodging related to the taxpayer's work;

Union dues and expenses;

Work clothes and uniforms if required and not suitable for everyday use; and

Work-related education.

New Federal Law (IRC section 67)

The provision suspends all miscellaneous itemized deductions that are subject to the two-percent floor under present law. Thus, under the provision, taxpayers may not claim the above-listed items as itemized deductions for the taxable years to which the suspension applies.

Effective Dates

The provision is effective for taxable years beginning after December 31, 2017, and before January 1, 2026.

[245] Under a special provision, these expenses are deductible ‘‘above the line" up to $250.

California Law (R&TC section 17076)

California conforms, under the PITL, to the federal rules relating to miscellaneous itemized deductions under IRC section 67, as of the specified date of January 1, 2015,[246] with modifications, but does not conform to the federal suspension of all miscellaneous itemized deductions.

Impact on California Revenue

Estimated Conformity Revenue Impact of Suspension of Miscellaneous Itemized Deductions For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	$2,200,000,000	$1,500,000,000	$1,600,000,000

Section	Section Title
11046	Suspension of Overall Limitation on Itemized Deductions

Background

The total amount of most otherwise allowable itemized deductions (other than the deductions for medical expenses, investment interest and casualty, theft or gambling losses) is limited for certain upper-income taxpayers.[247] All other limitations applicable to such deductions (such as the separate floors) are first applied and, then, the otherwise allowable total amount of itemized deductions is reduced by three percent of the amount by which the taxpayer's adjusted gross income exceeds a threshold amount.

For 2017, the threshold amounts are $261,500 for single taxpayers, $287,650 for heads of household, $313,800 for married couples filing jointly, and $156,900 for married taxpayers filing separately. These threshold amounts are indexed for inflation. The otherwise allowable itemized deductions may not be reduced by more than 80 percent by reason of the overall limit on itemized deductions.

New Federal Law (IRC section 68)

The provision repeals the overall limitation on itemized deductions.

[246] R&TC section 17024.5.
[247] IRC section 68.

Effective Dates

The provision is effective for taxable years beginning after December 31, 2017, and before January 1, 2026.

California Law (R&TC section 17077)

California conforms, under the PITL, to the overall limitation on itemized deductions as of the "specified date" of January 1, 2015,[248] with modifications, but does not conform to the federal repeal of the overall limitation on itemized deductions.

California provides its own indexed-for-inflation[249] limitation amounts. For 2017, the amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) is reduced by six percent of the amount of the taxpayer's AGI in excess of $187,203 for single or married-filing-separate/RDP taxpayers, $374,411 for married/RDP taxpayers filing a joint return, and $280,808 for taxpayers who file under the head-of-household status.

Impact on California Revenue

Estimated Conformity Revenue Impact of Suspension of Overall Limitation on Itemized Deductions For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	- $1,800,000,000	- $1,200,000,000	- $1,300,000,000

Section	Section Title
11047	Suspension of Exclusion for Qualified Bicycle Commuting Reimbursement

Background

Qualified bicycle commuting reimbursements of up to $20 per qualifying bicycle commuting month are excludible from an employee's gross income.[250] A qualifying bicycle commuting month is any month during which the employee regularly uses the bicycle for a substantial portion of travel to a place of employment and during which the employee does not receive transportation in a commuter highway vehicle, a transit pass, or qualified parking from an employer.

[248] R&TC section 17024.5.
[249] R&TC section 17077(c) provides that the limitation amounts are recomputed annually based on changes to the California Consumer Price Index under R&TC section 17041(h).
[250] IRC sections 132(a)(5) and 132(f)(1)(D).

Qualified reimbursements are any amount received from an employer during a 15-month period beginning with the first day of the calendar year as payment for reasonable expenses during a calendar year. Reasonable expenses are those incurred in a calendar year for the purchase of a bicycle and bicycle improvements, repair, and storage, if the bicycle is regularly used for travel between the employee's residence and place of employment.

Amounts that are excludible from gross income for income tax purposes are also excluded from wages for employment tax purposes.

New Federal Law (IRC section 132(f))

The provision suspends the exclusion from gross income and wages for qualified bicycle commuting reimbursements.

Effective Dates

The provision is effective for taxable years beginning after December 31, 2017, and before January 1, 2026.

California Law (R&TC sections 17131 and 17149)

California conforms, under the PITL, to the federal rules relating to the qualified bicycle commuting reimbursement exclusion from gross income and wages under IRC section 132(f), as of the specified date of January 1, 2015,[251] but does not conform to the federal suspension of this exclusion.

However, current California law additionally provides an exclusion from gross income for any compensation or the fair market value of any other benefit, except salary or wages, received by an employee from an employer for participation in any ridesharing arrangement in California, including an employee's bicycling to or from his or her place of work.[252] This enhanced exclusion is not subject to any limitation.

Impact on California Revenue

Estimated Conformity Revenue Impact of Suspension of Exclusion for Qualified Bicycle Commuting Reimbursement For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	$450,000	$200,000	$200,000

[251] R&TC section 17024.5.
[252] R&TC section 17149.

Section	Section Title
11048	Suspension of Exclusion for Qualified Moving Expense Reimbursement

Background

Qualified moving expense reimbursements are excluded from an employee's gross income,[253] and are defined as any amount received (directly or indirectly) from an employer as payment for (or reimbursement of) expenses which would be deductible as moving expenses under IRC section 217[254] if directly paid or incurred by the employee. However, any such amount actually deducted by the individual is not eligible for this exclusion. Amounts that are excludable from gross income for income tax purposes are also excluded from wages for employment tax purposes.

New Federal Law (IRC section 132(g))

The provision repeals the exclusion from gross income and wages for qualified moving expense reimbursements, except in the case of a member of the Armed Forces of the United States on active duty who moves pursuant to a military order.

Effective Dates

The provision is effective for taxable years beginning after December 31, 2017, and before January 1, 2026.

California Law (R&TC section 17131)

California conforms, under the PITL, to the federal rules relating to the qualified moving expense reimbursement exclusion from gross income under IRC section 132(g), as of the specified date of January 1, 2015,[255] but does not conform to the federal suspension of this exclusion.

[253] IRC section 132(a)(6) and 132(g).
[254] Individuals are allowed an itemized deduction for moving expenses paid or incurred during the taxable year in connection with the commencement of work by the taxpayer as an employee or as a self-employed individual at a new principal place of work. Such expenses are deductible only if the move meets certain conditions related to distance from the taxpayer's previous residence and the taxpayer's status as a full-time employee in the new location.
[255] R&TC section 17024.5.

Impact on California Revenue

Estimated Conformity Revenue Impact of Suspension of Exclusion for Qualified Moving Expense Reimbursement For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	$42,000,000	$27,000,000	$27,000,000

Section | Section Title
11049 | Suspension of Deduction for Moving Expenses

Background

Individuals are permitted an above-the-line deduction for moving expenses paid or incurred during the taxable year in connection with the commencement of work by the taxpayer as an employee or as a self-employed individual at a new principal place of work.[256] Such expenses are deductible only if the move meets certain conditions related to distance from the taxpayer's previous residence and the taxpayer's status as a full-time employee in the new location.

Special rules apply in the case of a member of the Armed Forces of the United States. In the case of any such individual who is on active duty, who moves pursuant to a military order and incident to a permanent change of station, the limitations related to distance from the taxpayer's previous residence and status as a full-time employee in the new location do not apply.[257] Additionally, any moving and storage expenses which are furnished in kind to such an individual, spouse, or dependents, or if such expenses are reimbursed or an allowance for such expenses is provided, such amounts are excluded from gross income.[258] Rules also apply to exclude amounts furnished to the spouse and dependents of such an individual in the event that such individuals move to a location other than to where the member of the Armed Forces is moving.

Present law provides income exclusions for various benefits provided to members of the Armed Forces.[259]

256 IRC section 217(a).
257 IRC section 217(g).
258 IRC section 217(g)(2).
259 IRC section 134.

New Federal Law (IRC section 217)

The provision generally suspends the deduction for moving expenses for taxable years 2018 through 2025. However, during that suspension period, the provision retains the deduction for moving expenses and the rules providing for exclusions of amounts attributable to in-kind moving and storage expenses (and reimbursements or allowances for these expenses) for members of the Armed Forces (or their spouse or dependents) on active duty that move pursuant to a military order and incident to a permanent change of station.

Effective Dates

The provision is effective for taxable years beginning after December 31, 2017, and before January 1, 2026.

California Law (R&TC section 17201)

California conforms, under the PITL, to the federal rules relating to the qualified moving expense deduction under IRC section 217, as of the specified date of January 1, 2015,[260] but does not conform to the federal suspension of this deduction.

Impact on California Revenue

Estimated Conformity Revenue Impact of Suspension of Deduction for Moving Expenses For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	$48,000,000	$32,000,000	$33,000,000

Section	Section Title
11050	Limitation on Wagering Losses

Background

Losses sustained during the taxable year on wagering transactions are allowed as a deduction only to the extent of the gains during the taxable year from such transactions.[261]

[260] R&TC section 17024.5.
[261] IRC section 165(d).

New Federal Law (IRC section 165(d))

The provision clarifies the scope of "losses from wagering transactions" as that term is used in IRC section 165(d). Under the provision, this term includes any deduction otherwise allowable under chapter 1 of the IRC incurred in carrying on any wagering transaction.

The provision is intended to clarify that the limitation on losses from wagering transactions applies not only to the actual costs of wagers incurred by an individual, but to other expenses incurred by the individual in connection with the conduct of that individual's gambling activity.[262] The provision clarifies, for instance, an individual's otherwise deductible expenses in traveling to or from a casino are subject to the limitation under IRC section 165(d).

Effective Dates

The provision is effective for taxable years beginning after December 31, 2017, and before January 1, 2026.

California Law (R&TC section 17201)

California conforms, under the PITL, to the federal rules relating to the deduction for losses from wagering transaction under IRC section 165(d), as of the specified date of January 1, 2015,[263] but does not conform to the federal limitation on the deduction.

Impact on California Revenue

Estimated Conformity Revenue Impact of Limitation on Wagering Losses For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	$1,700,000	$900,000	$900,000

[262] The provision thus reverses the result reached by the Tax Court in *Ronald A. Mayo v. Commissioner,* 136 T.C. 81 (2011). In that case, the Court held that a taxpayer's expenses incurred in the conduct of the trade or business of gambling, other than the cost of wagers, were not limited by IRC section 165(d), and were thus deductible under IRC section 162(a).
[263] R&TC section 17024.5.

Section	Section Title
11051	Repeal of Deduction for Alimony Payments

Background

Alimony and separate maintenance payments are deductible by the payor spouse and includible in income by the recipient spouse.[264] Child support payments are not treated as alimony.[265]

New Federal Law (IRC section 61, 71, 215, 682)

Under the provision, alimony and separate maintenance payments are not deductible by the payor spouse. The provision repeals the IRC provisions that specify that alimony and separate maintenance payments are included in income. Thus, the intent of the provision is to follow the rule of the United States Supreme Court's holding in *Gould v. Gould*,[266] in which the Court held that such payments are not income to the recipient. Income used for alimony payments is taxed at the rates applicable to the payor spouse rather than the recipient spouse. The treatment of child support is not changed.

Effective Dates

The provision is effective for any divorce or separation instrument executed after December 31, 2018, or for any divorce or separation instrument executed on or before December 31, 2018, and modified after that date, if the modification expressly provides that the amendments made by this section apply to such modification.

California Law (R&TC sections 17071, 17081, 17201, 17302, 17731, and 17737)

California conforms, under the PITL, to the federal rules relating to the deduction for alimony and separate maintenance payments under IRC section 215, as of the specified date of January 1, 2015,[267] but does not conform to the federal repeal of the deduction.

California conforms, under the PITL, to the federal rules relating to the inclusion of alimony and separate maintenance payments in income under IRC section 71, as of the specified date of January 1, 2015,[268] but does not conform to the federal repeal of the inclusion of such amounts in income.

[264] IRC sections 215(a), 61(a)(8) and 71(a).
[265] IRC section 71(c).
[266] 245 U.S. 151 (1917).
[267] R&TC section 17024.5.
[268] R&TC section 17024.5.

Impact on California Revenue

Estimated Conformity Revenue Impact of Repeal of Deduction for Alimony Payments For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	$4,900,000	$9,400,000	$16,000,000

Part VI—Increase in Estate and Gift Tax Exemption

Section	Section Title
11061	Increase in Estate and Gift Tax Exemption

Background

In General

A gift tax is imposed on certain lifetime transfers, and an estate tax is imposed on certain transfers at death. A generation-skipping transfer tax generally is imposed on transfers, either directly or in trust or similar arrangement, to a "skip person" (i.e., a beneficiary in a generation more than one generation younger than that of the transferor). Transfers subject to the generation-skipping transfer tax include direct skips, taxable terminations, and taxable distributions.

Income tax rules determine the recipient's tax basis in property acquired from a decedent or by gift. Gifts and bequests generally are excluded from the recipient's gross income.[269]

Common Features of the Estate, Gift and Generation-Skipping Transfer Taxes

Unified Credit (Exemption) and Tax Rates

Unified Credit.—A unified credit is available with respect to taxable transfers by gift and at death.[270] The unified credit offsets tax, computed using the applicable estate and gift tax rates, on a specified amount of transfers, referred to as the applicable exclusion amount, or exemption amount. The exemption amount was set at $5 million for 2011 and is indexed for inflation for

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[269] IRC section 102.
[270] IRC section 2010.

later years.[271] For 2017, the inflation-indexed exemption amount is $5.49 million.[272] Any exemption amount used during life to offset taxable gifts reduces the amount of exemption that remains at death to offset the value of a decedent's estate. An election is available under which exemption that is not used by a decedent may be used by the decedent's surviving spouse (exemption portability).

Common tax rate table.—A common tax-rate table with a top marginal tax rate of 40 percent is used to compute gift tax and estate tax. The 40-percent rate applies to transfers in excess of $1 million (to the extent not exempt). Because the exemption amount currently shields the first $5.49 million in gifts and bequests from tax, transfers in excess of the exemption amount generally are subject to tax at the highest marginal rate (40 percent).

Generation-Skipping Transfer Tax Exemption and Rate.—The generation-skipping transfer tax is a separate tax that can apply in addition to either the gift tax or the estate tax. The tax rate and exemption amount for generation-skipping transfer tax purposes, however, are set by reference to the estate tax rules. Generation-skipping transfer tax is imposed using a flat rate equal to the highest estate tax rate (40 percent). Tax is imposed on cumulative generation-skipping transfers in excess of the generation-skipping transfer tax exemption amount in effect for the year of the transfer. The generation-skipping transfer tax exemption for a given year is equal to the estate tax exemption amount in effect for that year (currently $5.49 million).

Transfers between spouses.—A 100-percent marital deduction generally is permitted for the value of property transferred between spouses.[273] In addition, transfers of “qualified terminable interest property” also are eligible for the marital deduction. Qualified terminable interest property is property: (1) that passes from the decedent, (2) in which the surviving spouse has a “qualifying income interest for life,” and (3) to which an election under these rules applies. A qualifying income interest for life exists if: (1) the surviving spouse is entitled to all the income from the property (payable annually or at more frequent intervals) or has the right to use the property during the spouse's life, and (2) no person has the power to appoint any part of the property to any person other than the surviving spouse.

A marital deduction generally is denied for property passing to a surviving spouse who is not a citizen of the United States. A marital deduction is permitted, however, for property passing to a qualified domestic trust of which the noncitizen surviving spouse is a beneficiary. A qualified domestic trust is a trust that has as its trustee at least one U.S. citizen or U.S. corporation. No corpus may be distributed from a qualified domestic trust unless the U.S. trustee has the right to withhold any estate tax imposed on the distribution.

Tax is imposed on (1) any distribution from a qualified domestic trust before the date of the death of the noncitizen surviving spouse and (2) the value of the property remaining in a qualified

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[271] For 2011 and later years, the gift and estate taxes were reunified, meaning that the gift tax exemption amount was increased to equal the estate tax exemption amount.
[272] For 2017, the $5.49 million exemption amount results in a unified credit of $2,141,800, after applying the applicable rates set forth in section 2001(c).
[273] IRC sections 2056 and 2523.

domestic trust on the date of death of the noncitizen surviving spouse. The tax is computed as an additional estate tax on the estate of the first spouse to die.

Transfers to Charity.—Contributions to IRC section 501(c)(3) charitable organizations and certain other organizations may be deducted from the value of a gift or from the value of the assets in an estate for Federal gift or estate tax purposes.[274] The effect of the deduction generally is to remove the full fair market value of assets transferred to charity from the gift or estate tax base; unlike the income tax charitable deduction, there are no percentage limits on the deductible amount. For estate tax purposes, the charitable deduction is limited to the value of the transferred property that is required to be included in the gross estate.[275] A charitable contribution of a partial interest in property, such as a remainder or future interest, generally is not deductible for gift or estate tax purposes.[276]

The Estate Tax

Overview

The IRC imposes a tax on the transfer of the taxable estate of a decedent who is a citizen or resident of the United States.[277] The taxable estate is determined by deducting from the value of the decedent's gross estate any deductions provided for in the IRC. After applying tax rates to determine a tentative amount of estate tax, certain credits are subtracted to determine estate tax liability.[278]

Because the estate tax shares a common unified credit (exemption) and tax rate table with the gift tax, the exemption amounts and tax rates are described together above, along with certain other common features of these taxes.

Gross Estate

A decedent's gross estate includes, to the extent provided for in other sections of the IRC, the date-of-death value of all of a decedent's property, real or personal, tangible or intangible, wherever situated.[279] In general, the value of property for this purpose is the fair market value of the property as of the date of the decedent's death, although an executor may elect to value

[274] IRC sections 2055 and 2522.
[275] IRC section 2055(d).
[276] IRC sections 2055(e)(2) and 2522(c)(2).
[277] IRC section 2001(a).
[278] More mechanically, the taxable estate is combined with the value of adjusted taxable gifts made during the decedent's life (generally, post-1976 gifts), before applying tax rates to determine a tentative total amount of tax. The portion of the tentative tax attributable to lifetime gifts is then subtracted from the total tentative tax to determine the gross estate tax, *i.e.*, the amount of estate tax before considering available credits. Credits are then subtracted to determine the estate tax liability. This method of computation was designed to ensure that a taxpayer only gets one run up through the rate brackets for all lifetime gifts and transfers at death, at a time when the thresholds for applying the higher marginal rates exceeded the exemption amount. However, the higher ($5.49 million) present-law exemption amount effectively renders the lower rate brackets irrelevant, because the top marginal rate bracket applies to all transfers in excess of $1 million. In other words, all transfers that are not exempt by reason of the $5.49 million exemption amount are taxed at the highest marginal rate of 40 percent.
[279] IRC section 2031(a).

certain property as of the date that is six months after the decedent's death (the alternate valuation date).[280]

The gross estate includes not only property directly owned by the decedent, but also other property in which the decedent had a beneficial interest at the time of his or her death.[281] The gross estate also includes certain transfers made by the decedent prior to his or her death, including: (1) certain gifts made within three years prior to the decedent's death;[282] (2) certain transfers of property in which the decedent retained a life estate;[283] (3) certain transfers taking effect at death;[284] and (4) revocable transfers.[285] In addition, the gross estate also includes property with respect to which the decedent had, at the time of death, a general power of appointment (generally, the right to determine who will have beneficial ownership).[286] The value of a life insurance policy on the decedent's life is included in the gross estate if the proceeds are payable to the decedent's estate or the decedent had incidents of ownership with respect to the policy at the time of his or her death.[287]

Deductions from the Gross Estate

A decedent's taxable estate is determined by subtracting from the value of the gross estate any deductions provided for in the IRC.

Marital and Charitable Transfers.—As described above, transfers to a surviving spouse or to charity generally are deductible for estate tax purposes. The effect of the marital and charitable deductions generally is to remove assets transferred to a surviving spouse or to charity from the estate tax base.

State Death Taxes.—An estate tax deduction is permitted for death taxes (e.g., any estate, inheritance, legacy, or succession taxes) actually paid to any State or the District of Columbia, in respect of property included in the gross estate of the decedent.[288] Such State taxes must have been paid and claimed before the later of: (1) four years after the filing of the estate tax return; or (2) (a) 60 days after a decision of the U.S. Tax Court determining the estate tax liability becomes final, (b) the expiration of the period of extension to pay estate taxes over time under IRC section 6166, or (c) the expiration of the period of limitations in which to file a claim for refund or 60 days after a decision of a court in which such refund suit has become final.

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[280] IRC section 2032.
[281] IRC section 2033.
[282] IRC section 2035.
[283] IRC section 2036.
[284] IRC section 2037.
[285] IRC section 2038.
[286] IRC section 2041.
[287] IRC section 2042.
[288] IRC section 2058.

Other Deductions.—A deduction is available for funeral expenses, estate administration expenses, and claims against the estate, including certain taxes.[289] A deduction also is available for uninsured casualty and theft losses incurred during the settlement of the estate.[290]

Credits Against Tax

After accounting for allowable deductions, a gross amount of estate tax is computed. Estate tax liability is then determined by subtracting allowable credits from the gross estate tax.

Unified Credit.—The most significant credit allowed for estate tax purposes is the unified credit, which is discussed in greater detail above.[291] For 2017, the value of the unified credit is $2,141,800, which has the effect of exempting $5.49 million in transfers from tax. The unified credit available at death is reduced by the amount of unified credit used to offset gift tax on gifts made during the decedent's life.

Other Credits.—Estate tax credits also are allowed for: (1) gift tax paid on certain pre-1977 gifts (before the estate and gift tax computations were integrated);[292] (2) estate tax paid on certain prior transfers (to limit the estate tax burden when estate tax is imposed on transfers of the same property in two estates by reason of deaths in rapid succession);[293] and (3) certain foreign death taxes paid (generally, where the property is situated in a foreign country but included in the decedent's U.S. gross estate).[294]

Provisions Affecting Small and Family-Owned Businesses and Farms

Special-Use Valuation.—An executor can elect to value for estate tax purposes certain “qualified real property” used in farming or another qualifying closely-held trade or business at its current-use value, rather than its fair market value.[295] The maximum reduction in value for such real property is $750,000 (adjusted for inflation occurring after 1997; the inflation-adjusted amount for 2017 is $1,120,000). In general, real property qualifies for special-use valuation only if (1) at least 50 percent of the adjusted value of the decedent's gross estate (including both real and personal property) consists of a farm or closely-held business property in the decedent's estate and (2) at least 25 percent of the adjusted value of the gross estate consists of farm or closely held business real property. In addition, the property must be used in a qualified use (e.g., farming) by the decedent or a member of the decedent's family for five of the eight years before the decedent's death.

If, after a special-use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years of the decedent's death, an additional estate tax is imposed to recapture the entire estate-tax benefit of the special-use valuation.

[289] IRC section 2053.
[290] IRC section 2054.
[291] IRC section 2010.
[292] IRC section 2012.
[293] IRC section 2013.
[294] IRC section 2014. In certain cases, an election may be made to deduct foreign death taxes. See section 2053(d).
[295] IRC section 2032A.

Installment Payment of Estate Tax for Closely Held Businesses — Under present law, the estate tax generally is due within nine months of a decedent's death. However, an executor generally may elect to pay estate tax attributable to an interest in a closely held business in two or more installments (but no more than 10).[296] An estate is eligible for payment of estate tax in installments if the value of the decedent's interest in a closely held business exceeds 35 percent of the decedent's adjusted gross estate (i.e., the gross estate less certain deductions). If the election is made, the estate may defer payment of principal and pay only interest for the first five years, followed by up to 10 annual installments of principal and interest. This provision effectively extends the time for paying estate tax by 14 years from the original due date of the estate tax. A special two-percent interest rate applies to the amount of deferred estate tax attributable to the first $1 million (adjusted annually for inflation occurring after 1998; the inflation-adjusted amount for 2017 is $1,490,000) in taxable value of a closely held business. The interest rate applicable to the amount of estate tax attributable to the taxable value of the closely held business in excess of $1 million (adjusted for inflation) is equal to 45 percent of the rate applicable to underpayments of tax under IRC section 6621 (i.e., 45 percent of the Federal short-term rate plus three percentage points).[297] Interest paid on deferred estate taxes is not deductible for estate or income tax purposes.

The Gift Tax

Overview

The IRC imposes a tax for each calendar year on the transfer of property by gift during such year by any individual, whether a resident or nonresident of the United States.[298] The amount of taxable gifts for a calendar year is determined by subtracting from the total amount of gifts made during the year: (1) the gift tax annual exclusion (described below); and (2) allowable deductions. Gift tax for the current taxable year is determined by: (1) computing a tentative tax on the combined amount of all taxable gifts for the current and all prior calendar years using the common gift tax and estate tax rate table; (2) computing a tentative tax only on all prior-year gifts; (3) subtracting the tentative tax on prior-year gifts from the tentative tax computed for all years to arrive at the portion of the total tentative tax attributable to current-year gifts; and, finally, (4) subtracting the amount of unified credit not consumed by prior-year gifts.

Because the gift tax shares a common unified credit (exemption) and tax rate table with the estate tax, the exemption amounts and tax rates are described together above, along with certain other common features of these taxes.

Transfers by Gift

The gift tax applies to a transfer by gift regardless of whether: (1) the transfer is made outright or in trust; (2) the gift is direct or indirect; or (3) the property is real or personal, tangible or

[296] IRC section 6166.
[297] The interest rate on this portion adjusts with the federal short-term rate.
[298] IRC section 2501(a).

intangible.[299] For gift tax purposes, the value of a gift of property is the fair market value of the property at the time of the gift.[300] Where property is transferred for less than full consideration, the amount by which the value of the property exceeds the value of the consideration is considered a gift and is included in computing the total amount of a taxpayer's gifts for a calendar year.[301]

For a gift to occur, a donor generally must relinquish dominion and control over donated property. For example, if a taxpayer transfers assets to a trust established for the benefit of his or her children, but retains the right to revoke the trust, the taxpayer may not have made a completed gift, because the taxpayer has retained dominion and control over the transferred assets. A completed gift made in trust, on the other hand, often is treated as a gift to the trust beneficiaries. By reason of statute, certain transfers are not treated as transfers by gift for gift tax purposes. These include, for example, certain transfers for educational and medical purposes,[302] transfers to IRC section 527 political organizations,[303] and transfers to tax-exempt organizations described in IRC sections 501(c)(4), (5), or (6).[304]

Taxable Gifts

As stated above, the amount of a taxpayer's taxable gifts for the year is determined by subtracting from the total amount of the taxpayer's gifts for the year the gift tax annual exclusion and any available deductions.

Gift Tax Annual Exclusion.—Under present law, donors of lifetime gifts are provided an annual exclusion of $14,000 per donee in 2017 (indexed for inflation from the 1997 annual exclusion amount of $10,000) for gifts of present interests in property during the taxable year.[305] If the non-donor spouse consents to split the gift with the donor spouse, then the annual exclusion is $28,000 per donee in 2017. In general, unlimited transfers between spouses are permitted without imposition of a gift tax. Special rules apply to contributions to a qualified tuition program (529 Plan), including an election to treat a contribution that exceeds the annual exclusion as a contribution made ratably over a five-year period beginning with the year of the contribution.[306]

Marital and Charitable Deductions.—As described above, transfers to a surviving spouse or to charity generally are deductible for gift tax purposes. The effect of the marital and charitable deductions generally is to remove assets transferred to a surviving spouse or to charity from the gift tax base.

[299] IRC section 2511(a).
[300] IRC section 2512(a).
[301] IRC section 2512(b).
[302] IRC section 2503(e).
[303] IRC section 2501(a)(4).
[304] IRC section 2501(a)(6).
[305] IRC section 2503(b).
[306] IRC section 529(c)(2).

The Generation-Skipping Transfer Tax

A generation-skipping transfer tax generally is imposed (in addition to the gift tax or the estate tax) on transfers, either directly or in trust or similar arrangement, to a "skip person" (*i.e.*, a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the generation-skipping transfer tax include direct skips, taxable terminations, and taxable distributions.

Exemption and Tax Rate

An exemption generally equal to the estate tax exemption amount ($5.49 million for 2017) is provided for each person making generation-skipping transfers. The exemption may be allocated by a transferor (or his or her executor) to transferred property, and in some cases is automatically allocated. The allocation of generation-skipping transfer tax exemption effectively reduces the tax rate on a generation-skipping transfer.

The tax rate on generation-skipping transfers is a flat rate of tax equal to the maximum estate and gift tax rate (40 percent) multiplied by the "inclusion ratio." The inclusion ratio with respect to any property transferred indicates the amount of "generation-skipping transfer tax exemption" allocated to a trust (or to property transferred in a direct skip) relative to the total value of property transferred.[307] If, for example, a taxpayer transfers $5 million in property to a trust and allocates $5 million of exemption to the transfer, the inclusion ratio is zero, and the applicable tax rate on any subsequent generation-skipping transfers from the trust is zero percent (40 percent multiplied by the inclusion ratio of zero). If, however, the taxpayer allocated only $2.5 million of exemption to the transfer, the inclusion ratio is 0.5, and the applicable tax rate on any subsequent generation-skipping transfers from the trust is 20 percent (40 percent multiplied by the inclusion ratio of 0.5). If the taxpayer allocates no exemption to the transfer, the inclusion ratio is one, and the applicable tax rate on any subsequent generation-skipping transfers from the trust is 40 percent (40 percent multiplied by the inclusion ratio of one).

Generation-Skipping Transfers

Generation-skipping transfer tax generally is imposed at the time of a generation-skipping transfer—a direct skip, a taxable termination, or a taxable distribution.

A direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person. A skip person may be a natural person or certain trusts. All persons assigned to the second or more remote generation below the transferor are skip persons (*e.g.*, grandchildren and great-grandchildren). Trusts are skip persons if (1) all interests in the trust are held by skip persons, or (2) no person holds an interest in the trust and at no time after the transfer may a distribution (including distributions and terminations) be made to a non-skip person.

[307] The inclusion ratio is one minus the applicable fraction. The applicable fraction is the amount of exemption allocated to a trust (or to a direct skip) divided by the value of assets transferred.

A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person.

A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or direct skip). If a transferor allocates generation-skipping transfer tax exemption to a trust prior to the taxable distribution, generation-skipping transfer tax may be avoided.

Income Tax Basis in Property Received

In General

Gain or loss, if any, on the disposition of property is measured by the taxpayer's amount realized (*i.e.*, gross proceeds received) on the disposition, less the taxpayer's basis in such property. Basis generally represents a taxpayer's investment in property with certain adjustments required after acquisition. For example, basis is increased by the cost of capital improvements made to the property and decreased by depreciation deductions taken with respect to the property.

A gift or bequest of appreciated (or loss) property is not an income tax realization event for the transferor. The IRC provides special rules for determining a recipient's basis in assets received by lifetime gift or from a decedent.

Basis in Property Received by Lifetime Gift

Under present law, property received from a donor of a lifetime gift generally takes a carryover basis. “Carryover basis” means that the basis in the hands of the donee is the same as it was in the hands of the donor. The basis of property transferred by lifetime gift also is increased, but not above fair market value, by any gift tax paid by the donor. The basis of a lifetime gift, however, generally cannot exceed the property's fair market value on the date of the gift. If a donor's basis in property is greater than the fair market value of the property on the date of the gift, then, for purposes of determining loss on a subsequent sale of the property, the donee's basis is the property's fair market value on the date of the gift.

Basis in Property Acquired From a Decedent

Property acquired from a decedent's estate generally takes a stepped-up basis. “Stepped-up basis” means that the basis of property acquired from a decedent's estate generally is the fair market value on the date of the decedent's death (or, if the alternate valuation date is elected, the earlier of six months after the decedent's death or the date the property is sold or distributed by the estate). Providing a fair market value basis eliminates the recognition of income on any appreciation of the property that occurred prior to the decedent's death and eliminates the tax benefit from any unrealized loss.

In community property states, a surviving spouse's one-half share of community property held by the decedent and the surviving spouse (under the community property laws of any State, U.S.

possession, or foreign country) generally is treated as having passed from the decedent and, thus, is eligible for stepped-up basis. Thus, both the decedent's one-half share and the surviving spouse's one-half share are stepped up to fair market value. This rule applies if at least one-half of the whole of the community interest is includible in the decedent's gross estate.

Stepped-up basis treatment generally is denied to certain interests in foreign entities. Stock in a passive foreign investment company (including those for which a mark-to-market election has been made) generally takes a carryover basis, except that stock of a passive foreign investment company for which a decedent shareholder had made a qualified electing fund election is allowed a stepped-up basis. Stock owned by a decedent in a domestic international sales corporation (or former domestic international sales corporation) takes a stepped-up basis reduced by the amount (if any) which would have been included in gross income under IRC section 995(c) as a dividend if the decedent had lived and sold the stock at its fair market value on the estate tax valuation date (i.e., generally the date of the decedent's death unless an alternate valuation date is elected).

New Federal Law (IRC section 2010)

The provision doubles the estate and gift tax exemption for estates of decedents dying and gifts made after December 31, 2017, and before January 1, 2026. This is accomplished by increasing the basic exclusion amount provided in IRC section 2010(c)(3) from $5 million to $10 million. The $10 million amount is indexed for inflation occurring after 2011.

As a conforming amendment to IRC section 2010(g) (regarding computation of estate tax), the provision provides that the Secretary shall prescribe regulations as may be necessary or appropriate to carry out the purposes of the section with respect to differences between the basic exclusion amount in effect: (1) at the time of the decedent's death; and (2) at the time of any gifts made by the decedent.

Effective Dates

The provision is effective for estates of decedents dying and gifts made after December 31, 2017, and before January 1, 2026.

California Law (R&TC section 13302)

Estate “Pick-Up” Tax

California does not conform to the federal estate and generation skipping transfer taxes. California law imposes what is referred to as the estate “pick-up” tax. The “pick-up” tax is administered by the State Controller’s Office (SCO), and is a tax equal to the maximum federal estate “state death tax credit” allowed. However, the federal estate “state death tax credit” has been repealed since 2005, thus with no federal estate “state death tax credit,” there is no state “pick up” tax.

California does not conform to the federal gift tax.

Impact on California Revenue

Not applicable.

Part VII—Extension of Time Limit for Contesting IRS Levy

Section	Section Title
11071	Extension of Time Limit for Contesting IRS Levy

Background

The IRS is authorized to return property that has been wrongfully levied upon.[308] In general, monetary proceeds from the sale of levied property may be returned within nine months of the date of the levy.

Generally, any person (other than the person against whom is assessed the tax out of which such levy arose) who claims an interest in levied property and that such property was wrongfully levied upon may bring a civil action for wrongful levy in a district court of the United States.[309] Generally, an action for wrongful levy must be brought within nine months from the date of levy.[310]

New Federal Law (IRC sections 6343 and 6532)

The provision extends from nine months to two years the period for returning the monetary proceeds from the sale of property that has been wrongfully levied upon.

The provision also extends from nine months to two years the period for bringing a civil action for wrongful levy.

Effective Dates

The provision is effective with respect to: (1) levies made after the date of enactment; and (2) levies made on or before the date of enactment provided that the nine-month period has not expired as of the date of enactment. The date of enactment is December 22, 2017.

California Law (California Code of Civil Procedure (CCP) sections 700.010-704.995, R&TC sections 18675, 19231-19236, 19306, 19382, 19384, 21016, and 21018)

California does not conform, under the AFITL, to IRC sections 6532 and 6343. Thus, the federal extension from nine months to two years for returning the monetary proceeds from the sale of

308 IRC section 6343.
309 IRC section 7426.
310 IRC section 6532.

property that has been wrongfully levied upon, and the time period for bringing a civil action for wrongful levy, are not applicable for California purposes.

CCP sections 700.010 through 704.995 and R&TC sections 19231 through 19236 govern the seizure and sale of real and personal property pursuant to a warrant, R&TC sections 18670 and 18671 govern orders to withhold, and CCP sections 706.020 through 706.154 govern withholding orders for taxes (wage garnishments). If the taxpayer believes that FTB's action is improper, they have a right to a hearing which must be requested within 30 days of the date that FTB issues a final notice before levy. A taxpayer may file a claim for reimbursement of charges and fees caused by an erroneous levy within 90 days of the erroneous action.[311] [312]

Generally, a claim for refund may be filed the latter of four years from the due date of the tax return, or one year from the date of overpayment.[313] Generally, a claim for refund requires that the balance due be paid in full to be acted upon by the FTB. For claims filed on or after January 1, 2002, full payment is not required to protect appeal rights (informal claims), but amounts paid more than seven years ago cannot be refunded.

A taxpayer may file an action to recover payment of tax within the later of: 90 days after notice by the FTB of the denial of a claim for refund, four years from the last day prescribed for filing the return for the taxable year, or within one year from the date the tax was paid.[314]

Impact on California Revenue

Not applicable.

Part VIII—Individual Mandate

Section	Section Title
11081	Elimination of Shared Responsibility Payment for Individuals Failing to Maintain Minimum Essential Coverage

Background

Under the Patient Protection and Affordable Care Act[315] (also called the Affordable Care Act, or ACA), individuals must be covered by a health plan that provides at least minimum essential

[311] R&TC section 21016.
[312] R&TC section 21018.
[313] R&TC section 19306.
[314] R&TC sections 19382 and 19384.
[315] Pubic Law Number 111-148.

coverage or be subject to a tax (also referred to as a penalty) for failure to maintain the coverage (commonly referred to as the "individual mandate").[316] Minimum essential coverage includes government-sponsored programs (including Medicare, Medicaid, and CHIP, among others), eligible employer-sponsored plans, plans in the individual market, grandfathered group health plans and grandfathered health insurance coverage, and other coverage as recognized by the Secretary of Health and Human Services (HHS) in coordination with the Secretary of the Treasury.[317] The tax is imposed for any month that an individual does not have minimum essential coverage unless the individual qualifies for an exemption for the month as described below.

The tax for any calendar month is one-twelfth of the tax calculated as an annual amount. The annual amount is equal to the greater of a flat dollar amount or an excess income amount. The flat dollar amount is the lesser of (1) the sum of the individual annual dollar amounts for the members of the taxpayer's family and (2) 300 percent of the adult individual dollar amount. The individual adult annual dollar amount is $695 for 2017 and 2018.[318] For an individual who has not attained age 18, the individual annual dollar amount is one half of the adult amount. The excess income amount is 2.5 percent of the excess of the taxpayer's household income for the taxable year over the threshold amount of income for requiring the taxpayer to file an income tax return.[319] The total annual household payment may not exceed the national average annual premium for bronze level health plans for the applicable family size offered through Exchanges (health plans offered in the individual market within a state[320]) that year.

Exemptions from the requirement to maintain minimum essential coverage are provided for the following: (1) an individual for whom coverage is unaffordable because the required contribution exceeds 8.16[321] percent of household income, (2) an individual with household income below the income tax return filing threshold, (3) a member of an Indian tribe, (4) a member of certain recognized religious sects or a health sharing ministry, (5) an individual with a coverage gap for a continuous period of less than three months, and (6) an individual who is determined by the Secretary of HHS to have suffered a hardship with respect to the capability to obtain coverage.[322]

New Federal Law (IRC section 5000A)

The provision reduces the amount of the individual responsibility payment, enacted as part of the Affordable Care Act, to zero.

[316] IRC section 5000A. If an individual is a dependent, as defined in IRC section 152, of another taxpayer, the other taxpayer is liable for any tax for failure to maintain the required coverage with respect to the individual.
[317] IRC section 5000A(f). Minimum essential coverage does not include coverage that consists of only certain excepted benefits, such as limited scope dental and vision benefits or long-term care insurance offered under a separate policy, certificate or contract.
[318] For years after 2016, the $695 amount is indexed to CPI-U, rounded to the next lowest multiple of $50.
[319] IRC section 6012(a).
[320] IRC section 5000A(f)(1)(C).
[321] For 2017. The rate applicable for 2018 is 8.06 percent of household income.
[322] In addition, certain individuals present or residing outside of the United States and bona fide residents of United States territories are deemed to maintain minimum essential coverage.

Effective Dates

The provision is effective with respect to health coverage status for months beginning after December 31, 2018.

California Law

The FTB does not administer these types of excise taxes.

Impact on California Revenue

The FTB does not administer these types of excise taxes.

Subtitle B—Alternative Minimum Tax

Section	Section Title
12001	Repeal of Tax for Corporations

Background

Corporate Alternative Minimum Tax

In General

An alternative minimum tax (AMT) is also imposed on a corporation to the extent the corporation's tentative minimum tax exceeds its regular tax. This tentative minimum tax is computed at the rate of 20 percent of the alternative minimum taxable income (AMTI) in excess of a $40,000 exemption amount that phases out. The exemption amount is phased out by an amount equal to 25 percent of the amount that the corporation's AMTI exceeds $150,000.

AMTI is the taxpayer's taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

A corporation with average gross receipts of less than $7.5 million for the prior three taxable years is exempt from the corporate minimum tax. The $7.5 million threshold is reduced to $5 million for the corporation's first three-taxable year period.

Preference Items in Computing AMTI

The corporate minimum tax preference items are:

The excess of the deduction for percentage depletion over the adjusted basis of the property at the end of the taxable year. This preference does not apply to percentage depletion allowed with respect to oil and gas properties.

The amount by which excess intangible drilling costs arising in the taxable year exceed 65 percent of the net income from oil, gas, and geothermal properties. This preference does not apply to an independent producer to the extent the preference would not reduce the producer's AMTI by more than 40 percent.

Tax-exempt interest income on private activity bonds (other than qualified 501(c)(3) bonds, certain housing bonds, and bonds issued in 2009 and 2010) issued after August 7, 1986.
Accelerated depreciation or amortization on certain property placed in service before January 1, 1987.

Adjustments in Computing AMTI

The adjustments that corporations must make in computing AMTI are:

Depreciation on property placed in service after 1986 and before January 1, 1999, must be computed by using the generally longer class lives prescribed by the alternative depreciation system of Internal Revenue Code (IRC) section 168(g) and either (a) the straight-line method in the case of property subject to the straight-line method under the regular tax or (b) the 150-percent declining balance method in the case of other property. Depreciation on property placed in service after December 31, 1998, is computed by using the regular tax recovery periods and the AMT methods described in the previous sentence. Depreciation on property which is allowed ''bonus depreciation" for the regular tax is computed without regard to any AMT adjustments.

Mining exploration and development costs must be capitalized and amortized over a 10-year period.

Taxable income from a long-term contract (other than a home construction contract) must be computed using the percentage of completion method of accounting.

The amortization deduction allowed for pollution control facilities placed in service before January 1, 1999, generally determined using 60-month amortization for a portion of the cost of the facility under the regular tax, must be calculated under the alternative depreciation system (generally, using longer class lives and the straight-line method). The amortization deduction allowed for pollution control facilities placed in service after December 31, 1998, is calculated using the regular tax recovery periods and the straight-line method.

The special rules applicable to Merchant Marine construction funds are not applicable.

The special deduction allowable under IRC section 833(b) for Blue Cross and Blue Shield organizations is not allowed.

The adjusted current earnings adjustment applies, as described below.

Adjusted Current Earning (ACE) Adjustment

The ACE adjustment is the amount equal to 75 percent of the amount by which the adjusted current earnings of a corporation exceed its AMTI (determined without the ACE adjustment and the alternative tax net operating loss deduction). In determining ACE the following rules apply:

For property placed in service before 1994, depreciation generally is determined using the straight-line method and the class life determined under the alternative depreciation system.

Amounts excluded from gross income under the regular tax but included for purposes of determining earnings and profits are generally included in determining ACE.

The inside build-up of a life insurance contract is included in ACE (and the related premiums are deductible).

Intangible drilling costs of integrated oil companies must be capitalized and amortized over a 60-month period.

The regular tax rules of IRC section 173 (allowing circulation expenses to be amortized) and IRC section 248 (allowing organizational expenses to be amortized) do not apply.

Inventory must be calculated using the FIFO, rather than LIFO, method.

The installment sales method generally may not be used.

No loss may be recognized on the exchange of any pool of debt obligations for another pool of debt obligations having substantially the same effective interest rates and maturities.

Depletion (other than for oil and gas properties) must be calculated using the cost, rather than the percentage, method.

In certain cases, the assets of a corporation that has undergone an ownership change must be stepped down to their fair market values.

Other Rules

The taxpayer's net operating loss carryover generally cannot reduce the taxpayer's AMT liability by more than 90 percent of AMTI determined without this deduction.

The various nonrefundable business credits allowed under the regular tax generally are not allowed against the AMT. Certain exceptions apply.

A corporation may elect to write off certain expenditures paid or incurred with respect of circulation expenses, research and experimental expenses, intangible drilling and development expenditures, development expenditures, and mining exploration expenditures over a specified period (three years in the case of circulation expenses, 60 months in the case of intangible drilling and development expenditures, and 10 years in case of other expenditures). The election applies for purposes of both the regular tax and the alternative minimum tax.

<u>New Federal Law (IRC section 55)</u>

The provision repeals the corporate AMT.

<u>Effective Dates</u>

The provisions are effective for taxable years beginning after December 31, 2017.

California Law (Revenue and Taxation Code (R&TC) section 23400)

California law conforms, under the Corporation Tax Law (CTL), to federal AMT rules as of the "specified date" of January 1, 2015, with modifications,[323] but California does not conform to the repeal of the corporate AMT.

Impact on California Revenue

Estimated Conformity Revenue Impact of Repeal of Tax for Corporations For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	- $170,000,000	- $160,000,000	- $150,000,000

Section	Section Title
12002	Credit for Prior Year Minimum Tax Liability of Corporations

Background

If a corporation is subject to AMT in any year, the amount of AMT is allowed as an AMT credit in any subsequent taxable year to the extent the taxpayer's regular tax liability exceeds its tentative minimum tax in the subsequent year. Corporations are allowed to claim a limited amount of AMT credits in lieu of bonus depreciation.

New Federal Law (IRC section 53)

The provision allows the AMT credit to offset the regular tax liability for any taxable year. In addition, the AMT credit is refundable for any taxable year beginning after 2017 and before 2022 in an amount equal to 50 percent (100 percent in the case of taxable years beginning in 2021) of the excess of the minimum tax credit for the taxable year over the amount of the credit allowable for the year against regular tax liability. Thus, the full amount of the minimum tax credit will be allowed in taxable years beginning before 2022.

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[323] R&TC section 23400 conforms to Part VI of Subchapter A of Chapter 1 of Subtitle A of the IRC, containing IRC sections 55 to 59, as of the "specified date" of January 1, 2015, with modifications.

Effective Dates

The provisions are effective for taxable years beginning after December 31, 2017.

California Law (R&TC section 23453)

California law conforms, under the CTL, to federal AMT credit rules as of the "specified date" of January 1, 2015, with modifications,[324] but California does not conform to the treatment of the tentative minimum tax as zero, thereby allowing the AMT credit to offset regular tax without limitation, or to the refundable AMT credit provisions.

Impact on California Revenue

Estimated Conformity Revenue Impact of Credit for Prior Year Minimum Tax Liability of Corporations For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	- $600,000,000	- $270,000,000	- $160,000,000

Section | Section Title
12003 | Increased Exemption for Individuals

Background

Individual Alternative Minimum Tax (AMT)

In General

An AMT is imposed on an individual, estate, or trust in an amount by which the tentative minimum tax exceeds the regular income tax for the taxable year. For taxable years beginning in 2017, the tentative minimum tax is the sum of (1) 26 percent of so much of the taxable excess as does not exceed $187,800 ($93,900 in the case of a married individual filing a separate return) and (2) 28 percent of the remaining taxable excess. The breakpoints are indexed for inflation. The taxable excess is so much of the AMTI as it exceeds the exemption amount. The maximum tax rates on net capital gain and dividends used in computing the regular tax are used in computing the tentative minimum tax. AMTI is the taxable income adjusted to take account of specified tax preferences and adjustments.

[324] R&TC sections 23051.5 and 23453.

The exemption amounts for taxable years beginning in 2017 are: (1) $84,500 in the case of married individuals filing a joint return and surviving spouses; (2) $54,300 in the case of other unmarried individuals; (3) $42,250 in the case of married individuals filing separate returns; and (4) $24,100 in the case of an estate or trust. For taxable years beginning in 2017, the exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $160,900 in the case of married individuals filing a joint return and surviving spouses, (2) $120,700 in the case of other unmarried individuals, and (3) $80,450 in the case of married individuals filing separate returns or an estate or a trust. The amounts are indexed for inflation.

AMTI is the taxpayer's taxable income increased by certain preference items and adjusted by determining the tax treatment of certain items in a manner that negates the deferral of income resulting from the regular tax treatment of those items.

Preference Items in Computing AMTI

The minimum tax preference items are:

The excess of the deduction for percentage depletion over the adjusted basis of each mineral property (other than oil and gas properties) at the end of the taxable year.

The amount by which excess intangible drilling costs (i.e., expenses in excess the amount that would have been allowable if amortized over a 10-year period) exceed 65 percent of the net income from oil, gas, and geothermal properties. This preference applies to independent producers only to the extent it reduces the producer's AMTI (determined without regard to this preference and the net operating loss deduction) by more than 40 percent.

Tax-exempt interest income on private activity bonds (other than qualified 501(c)(3) bonds, certain housing bonds, and bonds issued in 2009 and 2010) issued after August 7, 1986.

Accelerated depreciation or amortization on certain property placed in service before January 1, 1987.

Seven percent of the amount excluded from income under IRC section 1202 (relating to gains on the sale of certain small business stock).

In addition, losses from any tax shelter farm activity or passive activities are not taken into account in computing AMTI.

Adjustments in Computing AMTI

The adjustments that individuals must make to compute AMTI are:

Depreciation on property placed in service after 1986 and before January 1, 1999, is computed by using the generally longer class lives prescribed by the alternative depreciation system of IRC section 168(g) and either (a) the straight-line method in the case of property subject to the straight-line method under the regular tax or (b) the 150-percent declining balance method in the case of other property. Depreciation on property placed in service after December 31, 1998, is computed by using the regular tax recovery periods and the AMT methods described in the previous sentence. Depreciation on property acquired after September 10, 2001, which is allowed an additional allowance under IRC section 168(k) for the regular tax is computed without regard to any AMT adjustments.

Mining exploration and development costs are capitalized and amortized over a 10-year period.

Taxable income from a long-term contract (other than a home construction contract) is computed using the percentage of completion method of accounting.

The amortization deduction allowed for pollution control facilities placed in service before January 1, 1999, (generally determined using 60-month amortization for a portion of the cost of the facility under the regular tax), is calculated under the alternative depreciation system (generally, using longer class lives and the straight-line method). The amortization deduction allowed for pollution control facilities placed in service after December 31, 1998, is calculated using the regular tax recovery periods and the straight-line method.

Miscellaneous itemized deductions are not allowed.

Itemized deductions for State, local, and foreign real property taxes; State and local personal property taxes; State, local, and foreign income, war profits, and excess profits taxes; and State and local sales taxes are not allowed.

Medical expenses are allowed only to the extent they exceed ten percent of the taxpayer's adjusted gross income (AGI).

Deductions for interest on home equity[325] loans are not allowed.

The standard deduction and the deduction for personal exemptions are not allowed.

The amount allowable as a deduction for circulation expenditures is capitalized and amortized over a three-year period.

The amount allowable as a deduction for research and experimentation expenditures from passive activities is capitalized and amortized over a 10-year period.

The regular tax rules relating to incentive stock options do not apply.

[325] Amounts representing acquisition indebtedness are allowed.

Other Rules

The taxpayer's net operating loss deduction generally cannot reduce the taxpayer's AMTI by more than 90 percent of the AMTI (determined without the net operating loss deduction).

The alternative minimum tax foreign tax credit reduces the tentative minimum tax.
The various nonrefundable business credits allowed under the regular tax generally are not allowed against the AMT. Certain exceptions apply.

If an individual is subject to AMT in any year, the amount of tax exceeding the taxpayer's regular tax liability is allowed as a credit (the "AMT credit") in any subsequent taxable year to the extent the taxpayer's regular tax liability exceeds his or her tentative minimum tax liability in such subsequent year. The AMT credit is allowed only to the extent that the taxpayer's AMT liability is the result of adjustments that are timing in nature. The individual AMT adjustments relating to itemized deductions and personal exemptions are not timing in nature, and no minimum tax credit is allowed with respect to these items.

An individual may elect to write off certain expenditures paid or incurred with respect of circulation expenses, research and experimental expenses, intangible drilling and development expenditures, development expenditures, and mining exploration expenditures over a specified period (three years in the case of circulation expenses, 60 months in the case of intangible drilling and development expenditures, and 10 years in case of other expenditures). The election applies for purposes of both the regular tax and the alternative minimum tax.

<u>New Federal Law</u>

The provision temporarily increases both the exemption amount and the exemption amount phaseout thresholds for the individual AMT. Under the provision, the AMT exemption amount is increased to $109,400 for married taxpayers filing a joint return (half this amount for married taxpayers filing a separate return), and $70,300 for all other taxpayers (other than estates and trusts). The phaseout thresholds are increased to $1,000,000 for married taxpayers filing a joint return, and $500,000 for all other taxpayers (other than estates and trusts). These amounts are indexed for inflation.

<u>Effective Dates</u>

The provisions are effective for taxable years beginning after December 31, 2017, and before January 1, 2026.

California Law (IRC section 17062)

California conforms, under the Personal Income Tax Law (PITL), to federal AMT rules as of the "specified date" of January 1, 2015, with modifications.[326] As a result, the California AMT is similar to federal AMT in many respects, but the modifications relevant to this provision are that: (1) California has its own AMT exemption amounts and exemption phaseout thresholds (see tables below); and (2) the California AMT exemption and exemption phaseout threshold amounts are automatically indexed for inflation.[327] Therefore, this provision's modification of the AMT exemption and exemption threshold amounts does not apply to the California AMT.

California 2017 AMT Exemptions	
Filing status	**Amount**
Married/Registered Domestic Partner (RDP) filing jointly or qualifying widow(er)	$91,793
Single or head of household	$68,846
Married/RDP filing separately, estates, or trusts	$45,895

California 2017 AMT Exemption Phaseouts	
Filing status	**Amount**
Married/RDP filing jointly or qualifying widow(er)	$344,225
Single or head of household	$258,168
Married/RDP filing separately, estates, or trusts	$172,110

Impact on California Revenue

Not applicable.

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[326] For taxable years beginning on or after January 1, 2015, R&TC section 17062 conforms to Part VI of Subchapter A of Chapter 1 of Subtitle A of the IRC, containing IRC sections 55 to 59, as of the "specified date" of January 1, 2015, with modifications.

[327] For taxable years beginning after 1997, R&TC section 17062(b)(5) specifically modifies the exemption amounts in IRC section 55(d)(1), and provides California AMT exemption and phase-out amounts that are indexed annually for inflation.

Subtitle C—Business-Related Provisions

Part I – Corporate Provisions

Section	Section Title
13001	21-Percent Corporate Tax Rate

Background

In General

Under federal law, corporate taxable income is subject to tax under a four-step graduated rate structure.[328] The top corporate tax rate is 35 percent on taxable income in excess of $10 million. The corporate taxable income brackets and tax rates are as set forth in the table below.

Taxable Income	Tax rate (percent)
Not over $50,000	15
Over $50,000 but not over $75,000	25
Over $75,000 but not over $10,000,000	34
Over $10,000,000	35

An additional five-percent tax is imposed on a corporation's taxable income in excess of $100,000. The maximum additional tax is $11,750. Also, a second additional three-percent tax is imposed on a corporation's taxable income in excess of $15 million. The maximum second additional tax is $100,000.

Certain personal service corporations pay tax on their entire taxable income at the rate of 35 percent.[329]

Present law provides that, if the maximum corporate tax rate exceeds 35 percent, the maximum rate on a corporation's net capital gain is 35 percent.[330]

New Federal Law (IRC sections 11 and 1201)

The provision eliminates the graduated corporate rate structure and instead taxes corporate taxable income at 21 percent.

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[328] IRC section 11(a) and (b)(1).
[329] IRC section 11(b)(2).
[330] IRC section 1201(a).

The provision repeals the maximum corporate tax rate on net capital gain as obsolete.

In addition, for taxpayers subject to the normalization method of accounting (*e.g.,* regulated public utilities), the provision provides the normalization of excess tax reserves resulting from the reduction of corporate income tax rates (with respect to prior depreciation or recovery allowances taken on assets placed in service before the corporate rate reduction takes effect).

The excess tax reserve is the reserve for deferred taxes as of the day before the corporate rate reduction takes effect over what the reserve for deferred taxes would be if the corporate rate reduction had been in effect for all prior periods. If an excess tax reserve is reduced more rapidly or to a greater extent than such reserve would be reduced under the average rate assumption method, the taxpayer will not be treated as using a normalization method with respect to the corporate rate reduction. If the taxpayer does not use a normalization method of accounting for the corporate rate reduction, the taxpayer's tax for the taxable year shall be increased by the amount by which it reduces its excess tax reserve more rapidly than permitted under a normalization method of accounting and the taxpayer will not be treated as using a normalization method of accounting for purposes of IRC section 168(f)(2) and (i)(9)(C).[331]

The average rate assumption method[332] reduces the excess tax reserve over the remaining regulatory lives of the property that gave rise to the reserve for deferred taxes during the years in which the deferred tax reserve related to such property is reversing. Under this method, the excess tax reserve is reduced as the timing differences (*i.e.,* differences between tax depreciation and regulatory depreciation with respect to the property) reverse over the remaining life of the asset. The reversal of timing differences generally occurs when the amount of the tax depreciation taken with respect to an asset is less than the amount of the regulatory depreciation taken with respect to the asset. To ensure that the deferred tax reserve, including the excess tax reserve, is reduced to zero at the end of the regulatory life of the asset that generated the reserve, the amount of the timing difference which reverses during a taxable year is multiplied by the ratio of (1) the aggregate deferred taxes as of the beginning of the period in question to (2) the aggregate timing differences for the property as of the beginning of the period in question.

<u>Effective Dates</u>

The provision applies to taxable years beginning after December 31, 2017.

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[331] IRC section 168(f)(2) and (i)(9)(C) provide that if a taxpayer is required to use a normalization method of accounting with respect to public utility property and does not do so, such taxpayer must compute its depreciation allowances for Federal income tax purposes using the depreciation method, useful life determination, averaging convention, and salvage value limitation used for purposes of setting rates and reflecting operating results in its regulated books of account.

[332] See section 2.04 of Revenue Procedure 88-12, 1988-1 C.B. 637.

California Law (R&TC section 23151, 23153, 23186, 23501, 24349, and 24990)

Corporate Tax Rate

California does not conform to federal corporate tax rates, and therefore the corporate tax rate modifications are not applicable to California.

Instead, California has stand-alone provisions that imposes an 8.84 percent[333] franchise or income tax rate on the net income of a general corporation, except that, for a corporation doing business, incorporated or registered to do business in California, the tax imposed cannot be less than the minimum franchise tax of $800.[334]

In the case of a bank or financial corporation, the 8.84 percent tax is increased by an additional 2.0 percent.[335]

In the case of an "S" corporation, the tax rate is 1.5 percent.[336] If the "S" corporation is also a financial corporation, the tax rate is 3.5 percent.

Maximum Corporate Capital Gain Tax Rate

For taxable years beginning on or after January 1, 2015, R&TC section 24990 conforms to Subchapter P of Chapter 1 of Subtitle A of the IRC, containing IRC sections 1201 to 1298, as of the "specified date" of January 1, 2015, with modifications.[337] However, California does not conform to IRC section 1201[338] relating to the maximum corporate capital gain tax rate. California applies the ordinary tax rate to capital gains. As such, the federal repeal is not applicable to California.

Normalization of Accounting

California does not conform, under the CTL, to IRC section 168, relating to Modified Accelerated Cost Recovery System (MACRS) depreciation.

The CTL is in substantial conformity to the pre-1981 Class Life Asset Depreciation Range System (ADR) deduction. The ADR is based on the "useful life" of depreciable property.[339] As a result, the uncodified federal provisions relating to corporations (e.g., regulated public utilities) subject to the normalization method of accounting are not applicable to California.

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333 R&TC sections 23151 and 23501.
334 R&TC section 23153.
335 R&TC section 23186.
336 For taxable years beginning on or after January 1, 2015, R&TC section 24990 conforms to Subchapter P of Chapter 1 of Subtitle A of the IRC, containing IRC sections 1201 to 1298, as of the "specified date" of January 1, 2015, with modifications.
337 R&TC section 23051.5.
338 R&TC section 24990.5.
339 R&TC section 24349.

Impact on California Revenue

Not applicable.

Section	Section Title
13002	Reduction in Dividend Received Deductions to Reflect Lower Corporate Income Tax Rates

Background

Corporations are allowed a deduction with respect to dividends received from other taxable domestic corporations.[340] The amount of the deduction is generally equal to 70 percent of the dividend received.

In the case of any dividend received from a 20-percent owned corporation, the amount of the deduction is equal to 80 percent of the dividend received.[341] The term "20-percent owned corporation" means any corporation if 20 percent or more of the stock of such corporation (by vote and value) is owned by the taxpayer. For this purpose, certain preferred stock is not taken into account.

In the case of a dividend received from a corporation that is a member of the same affiliated group, a corporation is generally allowed a deduction equal to 100 percent of the dividend received.[342]

New Federal Law (IRC section 243)

The provision reduces the 70 percent dividends received deduction to 50 percent and the 80 percent dividends received deduction to 65 percent.[343]

Effective Dates

The provision applies to taxable years beginning after December 31, 2017.

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[340] IRC section 243(a). Such dividends are taxed at a maximum rate of 10.5 percent (30 percent of the top corporate tax rate of 35 percent).
[341] IRC section 243(c). Such dividends are taxed at a maximum rate of 7 percent (20 percent of the top corporate tax rate of 35 percent).
[342] IRC section 243(a)(3) and (b)(1). For this purpose, the term "affiliated group" generally has the meaning given such term by section 1504(a). IRC section 243(b)(2).
[343] Such dividends would be taxed at a maximum rate of 10.5 percent (50 percent of the top corporate tax rate of 21 percent) and 7.35 percent (35 percent of the top corporate tax rate of 21 percent), respectively.

California Law (R&TC section 24410)

California does not conform, under the CTL, to IRC section 243, relating to dividends received deduction, and therefore the modifications to the federal dividends received deduction are not applicable.

Instead, California has a stand-alone provision for a dividends received deduction,[344] for dividends received by a California corporation from an insurance company. The deduction is allowed whether or not the insurer is engaged in business in California, if at the time of each payment, at least 80 percent of each class of stock of the insurer was owned by the corporation receiving the dividend. An 85 percent deduction is allowed for qualified dividends. A portion of the dividends may not qualify if the insurer subsidiary paying the dividend is overcapitalized for the purpose of the dividends received deduction.

The California Court of Appeal[345] found R&TC section 24402 to be unconstitutional. For taxable years ending before December 1, 1999, taxpayers were allowed a full dividend received deduction, subject to the ownership limitations in R&TC section 24402(b). Due to the *Farmers Bros.* decision, for taxable years beginning on or after December 1, 1999, no deduction is be allowed under R&TC section 24402.

Water's-Edge Taxpayers

For water's-edge taxpayers with taxable years ending on or before December 1, 1999, a full dividends received deduction was allowed under R&TC section 24402. For taxable years beginning on or after December 1, 1999, a water's-edge taxpayer can instead use the 75 percent dividends received deduction allowed pursuant to R&TC section 24411. The deduction is applied to qualifying dividends to the extent not otherwise allowed as a deduction or eliminated from income. For taxable years ending on or after December 1, 1999, the regular foreign investment interest offset under R&TC section 24344(c) still applies.

Impact on California Revenue

Not applicable.

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[344] R&TC section 24410.
[345] *Farmer Bros. Co. v. Franchise Tax Board* (2003) 108 Cal App 4th 976, 134 Cal Rptr. 2nd 390.

Part II – Small Business Reforms

Section	Section Title
13101	Modifications of Rules for Expensing Depreciable Business Assets

Background

A taxpayer generally must capitalize the cost of property used in a trade or business or held for the production of income and recover such cost over time through annual deductions for depreciation or amortization.[346] Tangible property generally is depreciated under MACRS, which determines depreciation for different types of property based on an assigned applicable depreciation method, recovery period,[347] and convention.[348]

Election to Expense Certain Depreciable Business Assets

A taxpayer may elect under IRC section 179 to deduct (or "expense") the cost of qualifying property, rather than to recover such costs through depreciation deductions, subject to limitation. The maximum amount a taxpayer may expense is $500,000 of the cost of qualifying property placed in service for the taxable year.[349] The $500,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $2,000,000.[350] The $500,000 and $2,000,000 amounts are indexed for inflation for taxable years beginning after 2015.[351]

In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. Qualifying property also includes off-the-shelf computer software and qualified real property (*i.e.,* qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property).[352] Qualifying property excludes any property described in IRC section 50(b) (*i.e.,* certain property not eligible for the investment tax credit).[353]

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[346] See IRC sections 263(a) and 167. However, where property is not used exclusively in a taxpayer's business, the amount eligible for a deduction must be reduced by the amount related to personal use. See, *e.g.,* section 280A.
[347] The applicable recovery period for an asset is determined in part by statute and in part by historic Treasury guidance. Exercising authority granted by Congress, the Secretary issued Revenue Procedure 87-56, 1987-2 C.B. 674, laying out the framework of recovery periods for enumerated classes of assets. The Secretary clarified and modified the list of asset classes in Revenue Procedure 88-22, 1988-1 C.B. 785. In November 1988, Congress revoked the Secretary's authority to modify the class lives of depreciable property. Revenue Procedure 87-56, as modified, remains in effect except to the extent that the Congress has, since 1988, statutorily modified the recovery period for certain depreciable assets, effectively superseding any administrative guidance with regard to such property.
[348] IRC section 168.
[349] IRC section 179(b)(1).
[350] IRC section 179(b)(2).
[351] IRC section 179(b)(6).
[352] IRC section 179(d)(1)(A)(ii) and (f).
[353] IRC section 179(d)(1) flush language. Property described in section 50(b) is generally property used outside the United States, certain property used for lodging, property used by certain tax exempt organizations, and property used by governmental units and foreign persons or entities.

Passenger automobiles subject to the IRC section 280F limitation are eligible for IRC section 179 expensing only to the extent of the dollar limitations in IRC section 280F. For sport utility vehicles above the 6,000 pound weight rating and not more than the 14,000 pound weight rating, which are not subject to the limitation under IRC section 280F, the maximum cost that may be expensed for any taxable year under IRC section 179 is $25,000 (the "sport utility vehicle limitation").[354]

The amount eligible to be expensed for a taxable year may not exceed the taxable income for such taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision).[355] Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to limitations).

No general business credit under IRC section 38 is allowed with respect to any amount for which a deduction is allowed under IRC section 179.[356] If a corporation makes an election under IRC section 179 to deduct expenditures, the full amount of the deduction does not reduce earnings and profits. Rather, the expenditures that are deducted reduce corporate earnings and profits ratably over a five-year period.[357]

An expensing election is made under rules prescribed by the Secretary.[358] In general, any election or specification made with respect to any property may not be revoked except with the consent of the Commissioner. However, an election or specification under IRC section 179 may be revoked by the taxpayer without consent of the Commissioner.

<u>New Federal Law (IRC section 179)</u>

The provision increases the maximum amount a taxpayer may expense under IRC section 179 to $1,000,000, and increases the phaseout threshold amount to $2,500,000. Thus, the provision provides that the maximum amount a taxpayer may expense, for taxable years beginning after 2017, is $1,000,000 of the cost of qualifying property placed in service for the taxable year. The $1,000,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $2,500,000. The $1,000,000 and $2,500,000 amounts, as well as the $25,000 sport utility vehicle limitation, are indexed for inflation for taxable years beginning after 2018.

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[354] IRC section 179(b)(5). For this purpose, a sport utility vehicle is defined to exclude any vehicle that: (1) is designed for more than nine individuals in seating rearward of the driver's seat; (2) is equipped with an open cargo area, or a covered box not readily accessible from the passenger compartment, of at least six feet in interior length; or (3) has an integral enclosure, fully enclosing the driver compartment and load carrying device, does not have seating rearward of the driver's seat, and has no body section protruding more than 30 inches ahead of the leading edge of the windshield.
[355] IRC section 179(b)(3).
[356] IRC section 179(d)(9).
[357] IRC section 312(k)(3)(B).
[358] IRC section 179(c)(1).

The provision expands the definition of IRC section 179 property to include certain depreciable tangible personal property used predominantly to furnish lodging or in connection with furnishing lodging.[359]

The provision also expands the definition of qualified real property eligible for IRC section 179 expensing to include any of the following improvements to nonresidential real property placed in service after the date such property was first placed in service: roofs; heating, ventilation, and air-conditioning property; fire protection and alarm systems; and security systems.

Effective Dates

The provision applies to property placed in service in taxable years beginning after December 31, 2017.

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

California conforms, under the PITL and the CTL, to the IRC section 179 expensing provisions, as of the specified date of January 1, 2015, with modifications,[360] but does not conform to the federal maximum expense and phaseout threshold amounts, or the expanded qualified property definitions.[361] As a result, the federal modifications to these amounts are not applicable to California.

In addition, the CTL allows "additional first-year depreciation" of up to $10,000 per year. However, the CTL allows taxpayers to elect the IRC section 179 expensing deduction in lieu of "additional first-year depreciation." Property qualifying for "additional first-year depreciation" is similar to property qualifying under IRC section 179. However, a corporation is allowed only one or the other of the expensing deductions, not both.

For California, a corporate or personal income taxpayer may elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $200,000.

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[359] As defined in IRC section 50(b)(2). Property used predominantly to furnish lodging or in connection with furnishing lodging generally includes, *e.g.,* beds and other furniture, refrigerators, ranges, and other equipment used in the living quarters of a lodging facility such as an apartment house, dormitory, or any other facility (or part of a facility) where sleeping accommodations are provided and let. See Treasury Regulation section 1.48-1(h).
[360] R&TC sections 17024.5 and 23051.5.
[361] R&TC sections 17255 and 24356.

Impact on California Revenue

Estimated Conformity Revenue Impact of Modifications of Rules for Expensing Depreciable Business Assets For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	- $200,000	- $100,000	- $70,000

Section	Section Title
13102	Small Business Accounting Method Reform and Simplification

Background

General Rule for Methods of Accounting

IRC section 446 generally allows a taxpayer to select the method of accounting to be used to compute taxable income, provided that such method clearly reflects the income of the taxpayer. The term "method of accounting" includes not only the overall method of accounting used by the taxpayer, but also the accounting treatment of any one item.[362] Permissible overall methods of accounting include the cash receipts and disbursements method ("cash method"), an accrual method, or any other method (including a hybrid method) permitted under regulations prescribed by the Secretary.[363] Examples of any one item for which an accounting method may be adopted include cost recovery,[364] revenue recognition,[365] and timing of deductions.[366] For each separate trade or business, a taxpayer is entitled to adopt any permissible method, subject to certain restrictions.[367]

A taxpayer filing its first return may adopt any permissible method of accounting in computing taxable income for such year.[368] Except as otherwise provided, IRC section 446(e) requires taxpayers to secure consent of the Secretary before changing a method of accounting. The regulations under this section provide rules for determining: (1) what a method of accounting is, (2) how an adoption of a method of accounting occurs, and (3) how a change in method of accounting is effectuated.[369]

[362] Treasury Regulation section 1.446-1(a)(1).
[363] IRC section 446(c).
[364] See, *e.g.,* IRC sections 167 and 168.
[365] See, *e.g.,* IRC sections 451 and 460.
[366] See, *e.g.,* IRC sections 461 and 467.
[367] IRC section 446(d); Treasury Regulation section 1.446-1(d).
[368] Treasury Regulation section 1.446-1(e)(1).
[369] Treasury Regulation section 1.446-1(e).

Cash and Accrual Methods

Taxpayers using the cash method generally recognize items of income when actually or constructively received and items of expense when paid. The cash method is administratively easy and provides the taxpayer flexibility in the timing of income recognition. It is the method generally used by most individual taxpayers, including farm and nonfarm sole proprietorships.

Taxpayers using an accrual method generally accrue items of income when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy.[370] Taxpayers using an accrual method of accounting generally may not deduct items of expense prior to when all events have occurred that fix the obligation to pay the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred.[371] Accrual methods of accounting generally result in a more accurate measure of economic income than does the cash method. The accrual method is often used by businesses for financial accounting purposes.

A C corporation, a partnership that has a C corporation as a partner, or a tax-exempt trust or corporation with unrelated business income generally may not use the cash method. Exceptions are made for farming businesses, qualified personal service corporations, and the aforementioned entities to the extent their average annual gross receipts do not exceed $5 million for all prior years (including the prior taxable years of any predecessor of the entity) (the "gross receipts test"). The cash method may not be used by any tax shelter.[372] In addition, the cash method generally may not be used if the purchase, production, or sale of merchandise is an income producing factor.[373] Such taxpayers generally are required to keep inventories and use an accrual method with respect to inventory items.[374]

A farming business is defined as a trade or business of farming, including operating a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts, or other crops, timber, or ornamental trees.[375] Such farming businesses are not precluded from using the cash method regardless of whether they meet the gross receipts test. However, IRC section 447 generally requires a farming C corporation (and any farming partnership if a corporation is a partner in such

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[370] See, *e.g.,* IRC section 451.
[371] See, *e.g.,* IRC section 461.
[372] IRC sections 448(a)(3) and (d)(3) and 461(i)(3) and (4). For this purpose, a tax shelter includes: (1) any enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having the authority to regulate the offering of securities for sale; (2) any syndicate (within the meaning of section 1256(e)(3)(B)); or (3) any tax shelter as defined in section 6662(d)(2)(C)(ii).
In the case of a farming trade or business, a tax shelter includes any tax shelter as defined in section 6662(d)(2)(C)(ii) or any partnership or any other enterprise other than a corporation which is not an S corporation engaged in the trade or business of farming, (1) if at any time interests in such partnership or enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having authority to regulate the offering of securities for sale or (2) if more than 35 percent of the losses during any period are allocable to limited partners or limited entrepreneurs.
[373] Treasury Regulation sections 1.446-1(c)(2) and 1.471-1.
[374] IRC section 471 and Treasury Regulation sections 1.446-1(c)(2) and 1.471-1.
[375] IRC section 448(d)(1).

partnership) to use an accrual method of accounting. IRC section 447 does not apply to nursery or sod farms, to the raising or harvesting of trees (other than fruit and nut trees), nor to farming C corporations meeting a gross receipts test with a $1 million threshold. For family farm C corporations, the threshold under the gross receipts test is $25 million.

A qualified personal service corporation is a corporation: (1) substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and (2) substantially all of the stock of which is owned by current or former employees performing such services, their estates, or heirs.[376] Qualified personal service corporations are allowed to use the cash method without regard to whether they meet the gross receipts test.

Accounting for Inventories

In general, for Federal income tax purposes, taxpayers must account for inventories if the production, purchase, or sale of merchandise is an income-producing factor to the taxpayer.[377] Treasury regulations also provide that in any case in which the use of inventories is necessary to clearly reflect income, the accrual method must be used with regard to purchases and sales.[378] However, an exception is provided for taxpayers whose average annual gross receipts do not exceed $1 million.[379] A second exception is provided for taxpayers in certain industries whose average annual gross receipts do not exceed $10 million and that are not otherwise prohibited from using the cash method under IRC section 448.[380] Such taxpayers may account for inventory as materials and supplies that are not incidental (*i.e.*, “non-incidental materials and supplies”).[381]

In those circumstances in which a taxpayer is required to account for inventory, the taxpayer must maintain inventory records to determine the cost of goods sold during the taxable period. Cost of goods sold generally is determined by adding the taxpayer's inventory at the beginning of the period to the purchases made during the period and subtracting from that sum the taxpayer's inventory at the end of the period.

Because of the difficulty of accounting for inventory on an item-by-item basis, taxpayers often use conventions that assume certain item or cost flows. Among these conventions are the FIFO method, which assumes that the items in ending inventory are those most recently acquired by the taxpayer, and the LIFO method, which assumes that the items in ending inventory are those earliest acquired by the taxpayer.

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[376] IRC section 448(d)(2).
[377] IRC section 471(a) and Treasury Regulation section 1.471-1.
[378] Treasury Regulation section 1.446-1(c)(2).
[379] Revenue Procedure 2001-10, 2001-1 C.B. 272.
[380] Revenue Procedure 2002-28, 2002-1 C.B. 815.
[381] Treasury Regulation section 1.162-3(a)(1). A deduction is generally permitted for the cost of non-incidental materials and supplies in the taxable year in which they are first used or are consumed in the taxpayer's operations.

Uniform Capitalization

The uniform capitalization rules require certain direct and indirect costs allocable to real or tangible personal property produced by the taxpayer to be included in either inventory or capitalized into the basis of such property, as applicable.[382] For real or personal property acquired by the taxpayer for resale, IRC section 263A generally requires certain direct and indirect costs allocable to such property to be included in inventory.

IRC section 263A provides a number of exceptions to the general uniform capitalization requirements. One such exception exists for certain small taxpayers who acquire property for resale and have $10 million or less of average annual gross receipts;[383] such taxpayers are not required to include additional IRC section 263A costs in inventory. Another exception exists for taxpayers who raise, harvest, or grow trees.[384] Under this exception, IRC section 263A does not apply to trees raised, harvested, or grown by the taxpayer (other than trees bearing fruit, nuts, or other crops, or ornamental trees) and any real property underlying such trees. Similarly, the uniform capitalization rules do not apply to any plant having a preproductive period of two years or less or to any animal, which is produced by a taxpayer in a farming business (unless the taxpayer is required to use an accrual method of accounting under IRC section 447 or 448(a)(3)).[385] Freelance authors, photographers, and artists also are exempt from IRC section 263A for any qualified creative expenses.[386]

Accounting for Long-Term Contracts

In general, in the case of a long-term contract, the taxable income from the contract is determined under the percentage-of-completion method.[387] Under this method, the taxpayer must include in gross income for the taxable year an amount equal to the product of (1) the gross contract price and (2) the percentage of the contract completed during the taxable year.[388] The percentage of the contract completed during the taxable year is determined by comparing costs allocated to the contract and incurred before the end of the taxable year with the estimated total contract costs.[389] Costs allocated to the contract typically include all costs (including depreciation) that

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382 IRC section 263A.
383 IRC section 263A(b)(2)(B). No exception is available for small taxpayers who produce property subject to section 263A. However, a *de minimis* rule under Treasury regulations treats producers with total indirect costs of $200,000 or less as having no additional indirect costs beyond those normally capitalized for financial accounting purposes. Treasury Regulation section 1.263A-2(b)(3)(iv).
384 IRC section 263A(c)(5).
385 IRC section 263A(d).
386 IRC section 263A(h). Qualified creative expenses are defined as amounts paid or incurred by an individual in the trade or business of being a writer, photographer, or artist. However, such term does not include any expense related to printing, photographic plates, motion picture files, video tapes, or similar items.
387 IRC section 460(a).
388 See Treasury Regulation section 1.460-4. This calculation is done on a cumulative basis. Thus, the amount included in gross income in a particular year is that proportion of the expected contract price that the amount of costs incurred through the end of the taxable year bears to the total expected costs, reduced by the amounts of gross contract price included in gross income in previous taxable years.
389 IRC section 460(b)(1).

directly benefit or are incurred by reason of the taxpayer's long-term contract activities.[390] The allocation of costs to a contract is made in accordance with regulations.[391] Costs incurred with respect to the long-term contract are deductible in the year incurred, subject to general accrual method of accounting principles and limitations.[392]

An exception from the requirement to use the percentage-of-completion method is provided for certain construction contracts ("small construction contracts"). Contracts within this exception are those contracts for the construction or improvement of real property if the contract: (1) is expected (at the time such contract is entered into) to be completed within two years of commencement of the contract and (2) is performed by a taxpayer whose average annual gross receipts for the prior three taxable years do not exceed $10 million.[393] Thus, long-term contract income from small construction contracts must be reported consistently using the taxpayer's exempt contract method.[394] Permissible exempt contract methods include the completed contract method, the exempt-contract percentage-of-completion method, the percentage-of-completion method, or any other permissible method.[395]

New Federal Law (IRC sections 263A, 447, 448, 460, and 471)

The provision expands the universe of taxpayers that may use the cash method of accounting. Under the provision, the cash method of accounting may be used by taxpayers, other than tax shelters, that satisfy the gross receipts test, regardless of whether the purchase, production, or sale of merchandise is an income-producing factor. The gross receipts test allows taxpayers with annual average gross receipts that do not exceed $25 million for the three prior taxable-year period (the "$25 million gross receipts test") to use the cash method. The $25 million amount is indexed for inflation for taxable years beginning after 2018.

The provision expands the universe of farming C corporations (and farming partnerships with a C corporation partner) that may use the cash method to include any farming C corporation (or farming partnership with a C corporation partner) that meets the $25 million gross receipts test.

The provision retains the exceptions from the required use of the accrual method for qualified personal service corporations and taxpayers other than C corporations. Thus, qualified personal service corporations, partnerships without C corporation partners, S corporations, and other pass-through entities are allowed to use the cash method without regard to whether they meet the $25 million gross receipts test, so long as the use of such method clearly reflects income.[396]

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[390] IRC section 460(c).
[391] Treasury Regulation section 1.460-5.
[392] Treasury Regulation sections 1.460-4(b)(2)(iv) and 1.460-1(b)(8).
[393] IRC sections 460(e)(1)(B) and (4).
[394] Since such contracts involve the construction of real property, they are subject to the interest capitalization rules without regard to their duration. See Treasury Regulation section 1.263A-8.
[395] Treasury Regulation section 1.460-4(c)(1).
[396] Consistent with present law, the cash method generally may not be used by taxpayers, other than those that meet the $25 million gross receipts test, if the purchase, production, or sale of merchandise is an income-producing factor. In addition, the cash method may not be used by a tax shelter.

In addition, the provision also exempts certain taxpayers from the requirement to keep inventories. Specifically, taxpayers that meet the $25 million gross receipts test are not required to account for inventories under IRC section 471,[397] but rather may use a method of accounting for inventories that either (1) treats inventories as non-incidental materials and supplies,[398] or (2) conforms to the taxpayer's financial accounting treatment of inventories.[399]

The provision expands the exception for small taxpayers from the uniform capitalization rules. Under the provision, any producer or reseller that meets the $25 million gross receipts test is exempted from the application of IRC section 263A.[400] The provision retains the exemptions from the uniform capitalization rules that are not based on a taxpayer's gross receipts.

Finally, the provision expands the exception for small construction contracts from the requirement to use the percentage-of-completion method. Under the provision, contracts within this exception are those contracts for the construction or improvement of real property if the contract: (1) is expected (at the time such contract is entered into) to be completed within two years of commencement of the contract and (2) is performed by a taxpayer that (for the taxable year in which the contract was entered into) meets the $25 million gross receipts test.[401]

Under the provision, a taxpayer who fails the $25 million gross receipts test would not be eligible for any of the aforementioned exceptions (*i.e.,* from the accrual method, from keeping inventories, from applying the uniform capitalization rules, or from using the percentage-of completion method) for such taxable year.

Application of the provisions to expand the universe of taxpayers eligible to use the cash method, exempt certain taxpayers from the requirement to keep inventories, and expand the exception from the uniform capitalization rules is a change in the taxpayer's method of accounting for purposes of IRC section 481. Application of the exception for small construction contracts from the requirement to use the percentage-of-completion method is applied on a cutoff basis for all similarly classified contracts (hence there is no adjustment under IRC section 481(a) for contracts entered into before January 1, 2018).

<u>Effective Dates</u>

The provisions to expand the universe of taxpayers eligible to use the cash method, exempt certain taxpayers from the requirement to keep inventories, and expand the exception from the uniform capitalization rules apply to taxable years beginning after December 31, 2017. The

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[397] In the case of a sole proprietorship, the $25 million gross receipts test is applied as if the sole proprietorship is a corporation or partnership.
[398] Consistent with present law, a deduction is generally permitted for the cost of non-incidental materials and supplies in the taxable year in which they are first used or are consumed in the taxpayer's operations. See Treasury Regulation section 1.162-3(a)(1).
[399] The taxpayer's financial accounting treatment of inventories is determined by reference to the method of accounting used in the taxpayer's applicable financial statement or, if the taxpayer does not have an applicable financial statement, the method of accounting used in the taxpayer's book and records prepared in accordance with the taxpayer's accounting procedures.
[400] In the case of a sole proprietorship, the $25 million gross receipts test is applied as if the sole proprietorship is a corporation or partnership.
[401] Ibid.

provision to expand the exception for small construction contracts from the requirement to use the percentage-of-completion method applies to contracts entered into after December 31, 2017, in taxable years ending after such date.

California Law (R&TC sections 17201, 17551, 17564, 24422.3, 24652, 24652.5, 24673.2, and 24701)

Uniform Capitalization Rules (UNICAP)

California conforms, under the PITL and CTL, to the federal rules for capitalization and inclusion in inventory for costs of certain expenses, also known as the UNICAP rules, under IRC section 263A, as of the “specified date” of January 1, 2015,[402] but does not conform to expanded exceptions for small taxpayers from the UNICAP rules.

Method of Accounting for Corporations Engaged in Farming

California conforms, under the PITL and CTL, to the federal method of accounting rules for corporations engaged in farming, under IRC section 447, as of the “specified date” of January 1, 2015, with modifications, but does not conform to expansion of farming C corporations that can use the cash method of accounting.

Limitation on the Use of Cash Method of Accounting

California conforms, under the PITL and CTL, to the federal cash method of accounting rules and the limitations on which taxpayers can use the cash method of accounting under IRC section 448, as of the “specified date” of January 1, 2015, but does not conform to federal expansion of those rules for taxpayers that can use the cash method of accounting.

Special Rules for Long-Term Contracts

California conforms, under the PITL and CTL, to the federal special rules for long-term contracts, under IRC section 460, with modifications, as of the “specified date” of January 1, 2015, but does not conform to federal expansion of exceptions for small construction contracts from the requirement to use the percentage-of-completion method.

General Rule for Inventories

California conforms, under the PITL and CTL, to the federal general rule for inventories, under IRC section 471, as of the “specified date” of January 1, 2015, but does not conform to federal exemption of certain taxpayers from the requirement to keep inventories.

[402] R&TC section 17024.5 and 23051.5.

Impact on California Revenue

Estimated Conformity Revenue Impact of Small Business Accounting Method Reform and Simplification For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	- $360,000,000	- $190,000,000	- $90,000,000

Part III–Cost Recovery and Accounting Methods
Subpart A—Cost Recovery

Section	Section Title
13201	Temporary 100-Percent Expensing for Certain Business Assets

Background

A taxpayer generally must capitalize the cost of property used in a trade or business or held for the production of income and recover such cost over time through annual deductions for depreciation or amortization.[403]

Tangible Property

Tangible property generally is depreciated under MACRS, which determines depreciation for different types of property based on an assigned applicable depreciation method, recovery period,[404] and convention.[405]

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[403] See IRC sections 263(a) and 167. However, where property is not used exclusively in a taxpayer's business, the amount eligible for a deduction must be reduced by the amount related to personal use. See, *e.g.*, section 280A.
[404] The applicable recovery period for an asset is determined in part by statute and in part by historic Treasury guidance. Exercising authority granted by Congress, the Secretary issued Revenue Procedure 87-56, 1987-2 C.B. 674, laying out the framework of recovery periods for enumerated classes of assets. The Secretary clarified and modified the list of asset classes in Revenue Procedure 88-22, 1988-1 C.B. 785. In November 1988, Congress revoked the Secretary's authority to modify the class lives of depreciable property. Revenue Procedure 87-56, as modified, remains in effect except to the extent that the Congress has, since 1988, statutorily modified the recovery period for certain depreciable assets, effectively superseding any administrative guidance with regard to such property.
[405] IRC section 168.

Bonus Depreciation

An additional first-year depreciation deduction is allowed equal to 50 percent of the adjusted basis of qualified property acquired and placed in service before January 1, 2020, (January 1, 2021, for longer production period property[406] and certain aircraft).[407] [408] The 50-percent allowance is phased down for property placed in service after December 31, 2017, (after December 31, 2018, for longer production period property and certain aircraft). The bonus depreciation percentage rates are as follows:

Placed in Service Year	Bonus Depreciation Percentage	
	In General	Certain Aircraft
2017	50 percent	50 percent
2018	40 percent	50 percent[409]
2019	30 percent	40 percent
2020	None	30 percent[410]

The additional first-year depreciation deduction is allowed for both the regular tax and the alternative minimum tax ("AMT"),[411] but is not allowed in computing earnings and profits.[412] The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction.[413] The amount of the additional first-year depreciation deduction is not affected by a short taxable year.[414] The taxpayer may elect out of the additional first-year depreciation for any class of property for any taxable year.[415]

The interaction of the additional first-year depreciation allowance with the otherwise applicable depreciation allowance may be illustrated as follows. Assume that in 2017 a taxpayer purchases

[406] As defined in section 168(k)(2)(B).
[407] As defined in section 168(k)(2)(C).
[408] IRC section 168(k). The additional first-year depreciation deduction is generally subject to the rules regarding whether a cost must be capitalized under section 263A.
[409] It is intended that for longer production period property placed in service in 2018, 50 percent applies to the entire adjusted basis. Similarly, for longer production period property placed in service in 2019, 40 percent applies to the entire adjusted basis. A technical correction may be necessary with respect to longer production period property placed in service in 2018 and 2019 so that the statute reflects this intent.
[410] In the case of longer production period property described in section 168(k)(2)(B) and placed in service in 2020, 30 percent applies to the adjusted basis attributable to manufacture, construction, or production before January 1, 2020, and the remaining adjusted basis does not qualify for bonus depreciation. Thirty percent applies to the entire adjusted basis of certain aircraft described in section 168(k)(2)(C) and placed in service in 2020.
[411] IRC section 168(k)(2)(G). See also Treasury Regulation section 1.168(k)-1(d).
[412] IRC section 312(k)(3) and Treasury Regulation section 1.168(k)-1(f)(7).
[413] IRC section 168(k)(1)(B).
[414] *Ibid.*
[415] IRC section 168(k)(7). For the definition of a class of property, see Treasury Regulation section 1.168(k)-1(e)(2).

new depreciable property and places it in service.[416] The property's cost is $10,000, and it is five-year property subject to the 200 percent declining balance method and half-year convention. The amount of additional first-year depreciation allowed is $5,000. The remaining $5,000 of the cost of the property is depreciable under the rules applicable to five-year property. Thus, $1,000 also is allowed as a depreciation deduction in 2017.[417] The total depreciation deduction with respect to the property for 2017 is $6,000. The remaining $4,000 adjusted basis of the property generally is recovered through otherwise applicable depreciation rules.

Qualified Property

Property qualifying for the additional first-year depreciation deduction must meet all of the following requirements.[418] First, the property must be: (1) property to which MACRS applies with an applicable recovery period of 20 years or less; (2) water utility property;[419] (3) computer software other than computer software covered by IRC section 197; or (4) qualified improvement property.[420] Second, the original use[421] of the property must commence with the taxpayer.[422] Third, the taxpayer must acquire the property within the applicable time period (as described below). Finally, the property must be placed in service before January 1, 2020. As noted above, an extension of the placed-in-service date of one year (i.e., before January 1, 2021) is provided for certain property with a recovery period of 10 years or longer, certain transportation property, and certain aircraft.[423]

To qualify, property must be acquired (1) before January 1, 2020, or (2) pursuant to a binding written contract which was entered into before January 1, 2020. With respect to property that is

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[416] Assume that the cost of the property is not eligible for expensing under section 179 or Treasury Regulation section 1.263(a)-1(f).
[417] $1,000 results from the application of the half-year convention and the 200 percent declining balance method to the remaining $5,000.
[418] Requirements relating to actions taken before 2008 are not described herein since they have little (if any) remaining effect.
[419] As defined in section 168(e)(5).
[420] The additional first-year depreciation deduction is not available for any property that is required to be depreciated under the alternative depreciation system of MACRS. IRC section 168(k)(2)(D)(i).
[421] The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. If in the normal course of its business a taxpayer sells fractional interests in property to unrelated third parties, then the original use of such property begins with the first user of each fractional interest (*i.e.,* each fractional owner is considered the original user of its proportionate share of the property). Treasury Regulation section 1.168(k)-1(b)(3).
[422] A special rule applies in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was placed in service, the property would be treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback. If property is originally placed in service by a lessor, such property is sold within three months after the date that the property was placed in service, and the user of such property does not change, then the property is treated as originally placed in service by the taxpayer not earlier than the date of such sale. IRC section 168(k)(2)(E)(ii) and (iii).
[423] Property qualifying for the extended placed-in-service date must have an estimated production period exceeding one year and a cost exceeding $1 million. Transportation property generally is defined as tangible personal property used in the trade or business of transporting persons or property. Certain aircraft which is not transportation property, other than for agricultural or firefighting uses, also qualifies for the extended placed-in-service date, if at the time of the contract for purchase, the purchaser made a nonrefundable deposit of the lesser of 10 percent of the cost or $100,000, and which has an estimated production period exceeding four months and a cost exceeding $200,000.

manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property before January 1, 2020.[424] Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer.[425] For property eligible for the extended placed-in-service date, a special rule limits the amount of costs eligible for the additional first-year depreciation. With respect to such property, only the portion of the basis that is properly attributable to the costs incurred before January 1, 2020 ("progress expenditures") is eligible for the additional first-year depreciation deduction.[426]

Qualified Improvement Property

Qualified improvement property is any improvement to an interior portion of a building that is nonresidential real property if such improvement is placed in service after the date such building was first placed in service.[427] Qualified improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building.

Election to Accelerate AMT Credits in Lieu of Bonus Depreciation

A corporation otherwise eligible for additional first-year depreciation may elect to claim additional AMT credits in lieu of claiming additional depreciation with respect to qualified property.[428] In the case of a corporation making this election, the straight line method is used for the regular tax and the AMT with respect to qualified property.[429]

A corporation making an election increases the tax liability limitation under IRC section 53(c) on the use of minimum tax credits by the bonus depreciation amount. The aggregate increase in credits allowable by reason of the increased limitation is treated as refundable.

The bonus depreciation amount generally is equal to 20 percent of bonus depreciation for qualified property that could be claimed as a deduction absent an election under this provision.[430] As originally enacted, the bonus depreciation amount for all taxable years was limited to the lesser of (1) $30 million or (2) six percent of the minimum tax credits allocable to the adjusted net

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[424] IRC section 168(k)(2)(E)(i).
[425] Treasury Regulation section 1.168(k)-1(b)(4)(iii).
[426] IRC section 168(k)(2)(B)(ii). For purposes of determining the amount of eligible progress expenditures, rules similar to section 46(d)(3) as in effect prior to the Tax Reform Act of 1986 apply.
[427] IRC section 168(k)(3).
[428] IRC section 168(k)(4).
[429] IRC section 168(k)(4)(A)(ii).
[430] For this purpose, bonus depreciation is the difference between (i) the aggregate amount of depreciation determined if section 168(k)(1) applied to all qualified property placed in service during the taxable year and (ii) the amount of depreciation that would be so determined if section 168(k)(1) did not so apply. This determination is made using the most accelerated depreciation method and the shortest life otherwise allowable for each property.

minimum tax imposed for taxable years beginning before January 1, 2006. However, extensions of this provision have provided that this limitation applies separately to property subject to each extension.

For taxable years ending after December 31, 2015, the bonus depreciation amount for a taxable year (as defined under present law with respect to all qualified property) is limited to the lesser of (1) 50 percent of the minimum tax credit for the first taxable year ending after December 31, 2015, (determined before the application of any tax liability limitation) or (2) the minimum tax credit for the taxable year allocable to the adjusted net minimum tax imposed for taxable years ending before January 1, 2016, (determined before the application of any tax liability limitation and determined on a first-in, first-out basis).

All corporations treated as a single employer under IRC section 52(a) are treated as one taxpayer for purposes of the limitation, as well as for electing the application of this provision.[431]

In the case of a corporation making an election which is a partner in a partnership, for purposes of determining the electing partner's distributive share of partnership items, bonus depreciation does not apply to any qualified property and the straight line method is used with respect to that property.[432]

In the case of a partnership having a single corporate partner owning (directly or indirectly) more than 50 percent of the capital and profits interests in the partnership, each partner takes into account its distributive share of partnership depreciation in determining its bonus depreciation amount.[433]

Special Rules

Passenger Automobiles

The limitation under IRC section 280F on the amount of depreciation deductions allowed with respect to certain passenger automobiles is increased in the first year by $8,000 for automobiles that qualify (and for which the taxpayer does not elect out of the additional first-year deduction).[434] The $8,000 amount is phased down from $8,000 by $1,600 per calendar year beginning in 2018. Thus, the IRC section 280F increase amount for property placed in service during 2018 is $6,400, and during 2019 is $4,800. While the underlying IRC section 280F limitation is indexed for inflation,[435] the IRC section 280F increase amount is not indexed for inflation. The increase does not apply to a taxpayer who elects to accelerate AMT credits in lieu of bonus depreciation for a taxable year.

[431] IRC section 168(k)(4)(B)(iii).
[432] IRC section 168(k)(4)(D)(ii).
[433] IRC section 168(k)(4)(D)(iii).
[434] IRC section 168(k)(2)(F).
[435] IRC section 280F(d)(7).

Certain Plants Bearing Fruits and Nuts

A special election is provided for certain plants bearing fruits and nuts.[436] Under the election, the applicable percentage of the adjusted basis of a specified plant which is planted or grafted after December 31, 2015, and before January 1, 2020, is deductible for regular tax and AMT purposes in the year planted or grafted by the taxpayer, and the adjusted basis is reduced by the amount of the deduction.[437] The percentage is 50 percent for 2017, 40 percent for 2018, and 30 percent for 2019. A specified plant is any tree or vine that bears fruits or nuts, and any other plant that will have more than one yield of fruits or nuts and generally has a preproductive period of more than two years from planting or grafting to the time it begins bearing fruits or nuts.[438] The election is revocable only with the consent of the Secretary, and if the election is made with respect to any specified plant, such plant is not treated as qualified property eligible for bonus depreciation in the subsequent taxable year in which it is placed in service.

Long-Term Contracts

In general, in the case of a long-term contract, the taxable income from the contract is determined under the percentage-of-completion method.[439] Solely for purposes of determining the percentage of completion under IRC section 460(b)(1)(A), the cost of qualified property with a MACRS recovery period of seven years or less is taken into account as a cost allocated to the contract as if bonus depreciation had not been enacted for property placed in service before January 1, 2020, (January 1, 2021, in the case of longer production period property).[440]

Intangible Property

MACRS does not apply to certain property, including any motion picture film, video tape, or sound recording, or to any other property if the taxpayer elects to exclude such property from MACRS and the taxpayer properly applies a unit-of-production method or other method of depreciation not expressed in a term of years.[441] IRC section 197 (amortization of goodwill and certain other intangibles) does not apply to certain intangible property, including certain property produced by the taxpayer or any interest in a film, sound recording, video tape, book or similar property not acquired in a transaction (or a series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof.[442] Thus, the recovery of the cost of a film, video tape, or similar property that is produced by the taxpayer or is acquired on a "stand-alone" basis by the taxpayer may not be determined under either the MACRS depreciation provisions or under the IRC section 197 amortization provisions. The cost recovery of such property may be determined under IRC section 167, which allows a depreciation deduction for the reasonable allowance for the exhaustion, wear and tear, or obsolescence of the property if it is

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[436] See IRC section 168(k)(5).
[437] Any amount deducted under this election is not subject to capitalization under section 263A.
[438] A specified plant does not include any property that is planted or grafted outside the United States.
[439] IRC section 460.
[440] IRC section 460(c)(6). Other dates involving prior years are not described herein.
[441] IRC section 168(f)(1), (3) and (4).
[442] IRC section 197(c)(2) and (e)(4)(A). If section 197 applies to the acquisition of intangible assets held in connection with a trade or business, any value properly attributable to a "section 197 intangible" is amortizable on a straight-line basis over 15 years. IRC section 197(a) and (c).

used in a trade or business or held for the production of income. In addition, the costs of motion picture films, video tapes, sound recordings, copyrights, books, and patents are eligible to be recovered using the income forecast method of depreciation.[443]

Expensing of Certain Qualified Film, Television and Live Theatrical Productions

Under IRC section 181, a taxpayer may elect[444] to deduct the cost of any qualifying film, television and live theatrical production, commencing prior to January 1, 2017, in the year the expenditure is incurred in lieu of capitalizing the cost and recovering it through depreciation allowances.[445] A taxpayer may elect to deduct up to $15 million of the aggregate cost of the film or television production under this section.[446] The threshold is increased to $20 million if a significant amount of the production expenditures are incurred in areas eligible for designation as a low-income community or eligible for designation by the Delta Regional Authority as a distressed county or isolated area of distress.[447]

A qualified film, television or live theatrical production means any production of a motion picture (whether released theatrically or directly to video cassette or any other format), television program or live staged play if at least 75 percent of the total compensation expended on the production is for services performed in the United States by actors, directors, producers, and other relevant production personnel.[448] The term “compensation” does not include participations and residuals (as defined in IRC section 167(g)(7)(B)).[449]

Each episode of a television series is treated as a separate production, and only the first 44 episodes of a particular series qualify under the provision.[450] Qualified productions do not include sexually explicit productions as referenced by section 2257 of title 18 of the United States (U.S.) Code.[451]

A qualified live theatrical production is defined as a live staged production of a play (with or without music) which is derived from a written book or script and is produced or presented by a commercial entity in any venue which has an audience capacity of not more than 3,000, or a

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443 IRC section 167(g)(6). Under the income forecast method, a property's depreciation deduction for a taxable year is determined by multiplying the adjusted basis of the property by a fraction, the numerator of which is the gross income generated by the property during the year, and the denominator of which is the total forecasted or estimated gross income expected to be generated prior to the close of the tenth taxable year after the year the property is placed in service. Any costs that are not recovered by the end of the tenth taxable year after the property is placed in service may be taken into account as depreciation in that year. IRC section 167(g)(1).
444 See Treasury Regulation section 1.181-2 for rules on making an election under this section.
445 For this purpose, a qualified film or television production is treated as commencing on the first date of principal photography. The date on which a qualified live theatrical production commences is the date of the first public performance of such production for a paying audience.
446 IRC section 181(a)(2)(A). See Treasury Regulation section 1.181-1 for rules on determining eligible production costs.
447 IRC section 181(a)(2)(B).
448 IRC section 181(d)(3)(A).
449 IRC section 181(d)(3)(B).
450 IRC section 181(d)(2)(B).
451 IRC section 181(d)(2)(C).

series of venues the majority of which have an audience capacity of not more than 3,000.[452] In addition, qualified live theatrical productions include any live staged production which is produced or presented by a taxable entity no more than 10 weeks annually in any venue which has an audience capacity of not more than 6,500.[453] In general, in the case of multiple live-staged productions, each such live-staged production is treated as a separate production. Similar to the exclusion for sexually explicit productions from the definition of qualified film or television productions, qualified live theatrical productions do not include stage performances that would be excluded by section 2257(h)(1) of title 18 of the U.S. Code, if such provision were extended to live stage performances.[454]

For purposes of recapture under IRC section 1245, any deduction allowed under IRC section 181 is treated as if it were a deduction allowable for amortization.[455]

New Federal Law (IRC section 168)

In General

The provision extends and modifies the additional first-year depreciation deduction through 2026 (through 2027 for longer production period property and certain aircraft). The 50-percent allowance is increased to 100 percent for property placed in service after September 27, 2017, and before January 1, 2023, (January 1, 2024, for longer production period property and certain aircraft), as well as for specified plants planted or grafted after September 27, 2017, and before January 1, 2023. Thus, the provision repeals the phase-down of the 50-percent allowance for property placed in service after December 31, 2017, and for specified plants planted or grafted after such date. The 100-percent allowance is phased down by 20 percent per calendar year for property placed in service, and specified plants planted or grafted, in taxable years beginning after 2022 (after 2023 for longer production period property and certain aircraft). Under the provision, the bonus depreciation percentage rates are as follows:

Placed in Service Year[456]	Bonus Depreciation Percentage	
	Qualified Property in General	Certain Aircraft
2023	80 percent	100 percent
2024	60 percent	80 percent
2025	40 percent	60 percent
2026	20 percent	40 percent
2027	None	20 percent[457]

[452] IRC section 181(e)(2)(A).
[453] IRC section 181(e)(2)(D).
[454] IRC section 181(e)(2)(E).
[455] IRC section 1245(a)(2)(C).
[456] In the case of specified plants, this is the year of planting or grafting.
[457] Twenty percent applies to the adjusted basis attributable to manufacture, construction, or production before January 1, 2027, and the remaining adjusted basis does not qualify for bonus depreciation. Twenty percent applies to the entire adjusted basis of certain aircraft described in IRC section 168(k)(2)(C) and placed in service in 2027.

Application to Used Property

The provision removes the requirement that the original use of qualified property must commence with the taxpayer. Thus, the provision applies to purchases of used as well as new items. To prevent abuses, the additional first-year depreciation deduction applies only to property purchased in an arm's-length transaction. It does not apply to property received as a gift or from a decedent.[458] In the case of trade-ins, like-kind exchanges, or involuntary conversions, it applies only to any money paid in addition to the traded-in property or in excess of the adjusted basis of the replaced property.[459] It does not apply to property acquired in a nontaxable exchange such as a reorganization, to property acquired from a member of the taxpayer's family, including a spouse, ancestors, and lineal descendants, or from another related entity as defined in IRC section 267, nor to property acquired from a person who controls, is controlled by, or is under common control with, the taxpayer.[460] Thus it does not apply, for example, if one member of an affiliated group of corporations purchases property from another member, or if an individual who controls a corporation purchases property from that corporation.

Special Rules

The provision maintains the IRC section 280F increase amount of $8,000 for passenger automobiles placed in service after December 31, 2017.

The provision extends the special rule under the percentage-of-completion method for the allocation of bonus depreciation to a long-term contract for property placed in service before January 1, 2027, (January 1, 2028, in the case of longer production period property).

Application to Qualified Film, Television and Live Theatrical Productions

The provision expands the definition of qualified property eligible for the additional first-year depreciation allowance to include qualified film, television and live theatrical productions[461] placed in service after September 27, 2017, and before January 1, 2027, for which a deduction otherwise would have been allowable under IRC section 181 without regard to the dollar limitation or termination of such section. For purposes of this provision, a production is considered placed in service at the time of initial release, broadcast, or live staged performance (i.e., at the time of the first commercial exhibition, broadcast, or live staged performance of a production to an audience).

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[458] By reference to IRC section 179(d)(2)(C). See also Treasury Regulation section 1.179-4(c)(1)(iv).
[459] By reference to IRC section 179(d)(3). See also Treasury Regulation section 1.179-4(d).
[460] By reference to IRC section 179(d)(2)(A) and (B).
See also Treasury Regulation section 1.179-4(c).
[461] As defined in section 181(d) and (e).

Exception for Certain Businesses Not Subject to Limitation on Interest Expense

The provision excludes from the definition of qualified property any property which is primarily used in the trade or business of the furnishing or sale of (1) electrical energy, water, or sewage disposal services, (2) gas or steam through a local distribution system, or (3) transportation of gas or steam by pipeline, if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or by the governing or ratemaking body of an electric cooperative.

In addition, the provision excludes from the definition of qualified property any property used in a trade or business that has had floor plan financing indebtedness, unless the taxpayer with such trade or business is not a tax shelter prohibited from using the cash method and is exempt from the interest limitation rules by meeting the small business gross receipts test of IRC section 448(c).

Transition Rule

The present-law phase-down of bonus depreciation is maintained for property acquired before September 28, 2017, and placed in service after September 27, 2017. Under the provision, in the case of property acquired and adjusted basis incurred before September 28, 2017, the bonus depreciation rates are as follows:

Phase-Down for Portion of Basis of Qualified Property Acquired before September 28, 2017

Placed in Service Year	Bonus Depreciation Percentage	
	Qualified Property in General	Certain Aircraft
2017	50 percent	50 percent
2018	40 percent	50 percent
2019	30 percent	40 percent
2020	None	30 percent

Similarly, the IRC section 280F increase amount in the limitation on the depreciation deductions allowed with respect to certain passenger automobiles acquired before September 28, 2017, and placed in service after September 27, 2017, is $8,000 for 2017, $6,400 for 2018, and $4,800 for 2019.

As a conforming amendment to the repeal of corporate AMT, the provision repeals the election to accelerate AMT credits in lieu of bonus depreciation.

Effective Dates

The provision generally applies to property acquired and placed in service after September 27, 2017, and to specified plants planted or grafted after such date.

A transition rule provides that, for a taxpayer's first taxable year ending after September 27, 2017, the taxpayer may elect, in the time and manner prescribed by the Secretary, to apply a 50-percent allowance instead of the 100-percent allowance.

California Law (R&TC sections 17201, 17250, 24349, and 24356)

California conforms, under the PITL, to the federal rules relating to MACRS depreciation, under IRC section 168, as of the "specified date" of January 1, 2015.[462] However, the PITL specifically does not conform to bonus depreciation;[463] thus, the provision that modifies and extends bonus depreciation is not applicable under the PITL.

California does not conform, under the CTL, to IRC section 168, relating to MACRS depreciation. The CTL is in substantial conformity to the pre-1981 ADR deductions. The ADR is based on the "useful life" of depreciable property.[464]

The CTL allows "additional first-year depreciation" of up to $10,000 per year. However, the CTL allows taxpayers to elect the IRC section 179 expensing deduction in lieu of "additional first-year depreciation." Property qualifying for "additional first-year depreciation" is similar to property qualifying under IRC section 179. However, a corporation is allowed only one or the other of the expensing deductions, not both.

Impact on California Revenue

Not applicable.

Section	Section Title
13202	Modifications to Depreciation Limitations on Luxury Automobiles and Personal Use Property

[462] R&TC sections 17024.5 and 23051.5.
[463] R&TC section 17250(a)(4).
[464] R&TC section 24349.

Background

IRC section 280F(a) limits the annual cost recovery deduction with respect to certain passenger automobiles. This limitation is commonly referred to as the "luxury automobile depreciation limitation." For passenger automobiles placed in service in 2017, and for which the additional first-year depreciation deduction under IRC section 168(k) is not claimed, the maximum amount of allowable depreciation is $3,160 for the year in which the vehicle is placed in service, $5,100 for the second year, $3,050 for the third year, and $1,875 for the fourth and later years in the recovery period.[465] This limitation is indexed for inflation and applies to the aggregate deduction provided under present law for depreciation and IRC section 179 expensing. Hence, passenger automobiles subject to IRC section 280F are eligible for IRC section 179 expensing only to the extent of the applicable limits contained in IRC section 280F. For passenger automobiles eligible for the additional first-year depreciation allowance in 2017, the first-year limitation is increased by an additional $8,000.[466]

For purposes of the depreciation limitation, passenger automobiles are defined broadly to include any four-wheeled vehicles that are manufactured primarily for use on public streets, roads, and highways and which are rated at 6,000 pounds unloaded gross vehicle weight or less.[467] In the case of a truck or a van, the depreciation limitation applies to vehicles that are rated at 6,000 pounds gross vehicle weight or less. Sport utility vehicles are treated as a truck for the purpose of applying the IRC section 280F limitation.

Basis not recovered in the recovery period of a passenger automobile is allowable as an expense in subsequent taxable years.[468] The expensed amount is limited in each such subsequent taxable year to the amount of the limitation in the fourth year in the recovery period.

Listed Property

In the case of certain listed property, special rules apply. Listed property generally is defined as (1) any passenger automobile; (2) any other property used as a means of transportation;[469] (3) any property of a type generally used for purposes of entertainment, recreation, or amusement; (4) any computer or peripheral equipment;[470] and (5) any other property of a type specified in Treasury regulations.[471]

[465] Revenue Procedure 2017-29, Table 3, 2017-14 I.R.B. 1065.
[466] IRC section 168(k)(2)(F). For proposed changes to section 168(k), see section II.B.1. of this document (Increased expensing).
[467] IRC section 280F(d)(5). Exceptions are provided for any ambulance, hearse, or combination ambulance-hearse used by the taxpayer directly in a trade or business, or any vehicle used by the taxpayer directly in the trade or business of transporting persons or property for compensation or hire.
[468] IRC section 280F(a)(1)(B).
[469] Property substantially all of the use of which is in a trade or business of providing transportation to unrelated persons for hire is not considered other property used as a means of transportation. IRC section 280F(d)(4)(C).
[470] Computer or peripheral equipment used exclusively at a regular business establishment and owned or leased by the person operating such establishment, however, is not listed property. IRC section 280F(d)(4)(B).
[471] IRC section 280F(d)(4)(A).

First, if for the taxable year in which the property is placed in service, the use of the property for trade or business purposes does not exceed 50 percent of the total use of the property, then the depreciation deduction with respect to such property is determined under the alternative depreciation system.[472] The alternative depreciation system generally requires the use of the straight-line method and a recovery period equal to the class life of the property.[473] Second, if an individual owns or leases listed property that is used by the individual in connection with the performance of services as an employee, no depreciation deduction, expensing allowance, or deduction for lease payments is available with respect to such use unless the use of the property is for the convenience of the employer and required as a condition of employment.[474] Both limitations apply for purposes of IRC section 179 expensing.

For listed property, no deduction is allowed unless the taxpayer adequately substantiates the expense and business usage of the property.[475] A taxpayer must substantiate the elements of each expenditure or use of listed property, including (1) the amount (*e.g.,* cost) of each separate expenditure and the amount of business or investment use, based on the appropriate measure (*e.g.,* mileage for automobiles), and the total use of the property for the taxable period, (2) the date of the expenditure or use, and (3) the business purposes for the expenditure or use.[476] The level of substantiation for business or investment use of listed property varies depending on the facts and circumstances. In general, the substantiation must contain sufficient information as to each element of every business or investment use.[477]

<u>New Federal Law (IRC section 280F)</u>

The provision increases the depreciation limitations under IRC section 280F that apply to listed property. For passenger automobiles placed in service after December 31, 2017, and for which the additional first-year depreciation deduction under IRC section 168(k) is not claimed, the maximum amount of allowable depreciation is $10,000 for the year in which the vehicle is placed in service, $16,000 for the second year, $9,600 for the third year, and $5,760 for the fourth and later years in the recovery period.[478] The limitations are indexed for inflation for passenger automobiles placed in service after 2018.

The provision removes computer or peripheral equipment from the definition of listed property. Such property is therefore not subject to the heightened substantiation requirements that apply to listed property.

[472] IRC section 280F(b)(1). If for any taxable year after the year in which the property is placed in service the use of the property for trade or business purposes decreases to 50 percent or less of the total use of the property, then the amount of depreciation allowed in prior years in excess of the amount of depreciation that would have been allowed for such prior years under the alternative depreciation system is recaptured (*i.e.,* included in gross income) for such taxable year.
[473] IRC section 168(g).
[474] IRC section 280F(d)(3).
[475] IRC section 274(d)(4).
[476] Temp. Reg. section 1.274-5T(b)(6).
[477] Temp. Reg. section 1.274-5T(c)(2)(ii)(C).
[478] Revenue Procedure 2017-29, Table 3, 2017-14 I.R.B. 1065.

Effective Dates

The provision is effective for property placed in service after December 31, 2017, in taxable years ending after such date.

California Law (R&TC sections 17201 and 24349.1)

California conforms, under the PITL and the CTL, to the federal rules for listed property under IRC section 280F as of the "specified date" of January 1, 2015,[479] with modifications under the CTL, but does not conform to the federal modifications to depreciation limitations on luxury automobiles and personal use property.

Impact on California Revenue

Estimated Conformity Revenue Impact of Modifications to Depreciation Limitations on Luxury Automobiles and Personal Use Property For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	- $35,000,000	- $40,000,000	- $45,000,000

Section	Section Title
13203	Modifications of Treatment of Certain Farm Property

Background

A taxpayer generally must capitalize the cost of property used in a trade or business or held for the production of income and recover such cost over time through annual deductions for depreciation or amortization.[480] Tangible property generally is depreciated under MACRS, which determines depreciation for different types of property based on an assigned applicable depreciation method, recovery period, and convention.[481]

The applicable recovery period for an asset is determined in part by statute and in part by historical Treasury guidance.[482] The "type of property" of an asset is used to determine the "class life" of the asset, which in turn dictates the applicable recovery period for the asset.

[479] R&TC sections 17024.5 and 23051.5.
[480] See IRC sections 263(a) and 167. However, where property is not used exclusively in a taxpayer's business, the amount eligible for a deduction must be reduced by the amount related to personal use. See, e.g., section 280A.
[481] IRC section 168.
[482] Exercising authority granted by Congress, the Secretary issued Revenue Procedure 87-56, 1987-2 C.B. 674, laying out the framework of recovery periods for enumerated classes of assets. The Secretary clarified and modified the list of asset classes in Revenue Procedure 88-22, 1988-1 C.B. 785. In November 1988, Congress revoked the Secretary's authority to modify the class lives of depreciable property. Revenue Procedure 87-56, as modified,

The MACRS recovery periods applicable to most tangible personal property range from three to 20 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods,[483] switching to the straight line method for the first taxable year where using the straight line method with respect to the adjusted basis as of the beginning of that year yields a larger depreciation allowance. The recovery periods for most real property are 39 years for nonresidential real property and 27.5 years for residential rental property. The straight line depreciation method is required for the aforementioned real property.

Property used in a farming business is assigned various recovery periods in the same manner as other business property. For example, depreciable assets used in agriculture activities that are assigned a recovery period of 7 years include machinery and equipment, grain bins, and fences (but no other land improvements), that are used in the production of crops or plants, vines, and trees; livestock; the operation of farm dairies, nurseries, greenhouses, sod farms, mushrooms cellars, cranberry bogs, apiaries, and fur farms; and the performance of agriculture, animal husbandry, and horticultural services.[484] Cotton ginning assets are also assigned a recovery period of 7 years.[485] Any single purpose agricultural or horticultural structure,[486] and any tree or vine bearing fruit or nuts are assigned a recovery period of 10 years.[487] Land improvements such as drainage facilities, paved lots, and water wells are assigned a recovery period of 15 years.[488]

A 5-year recovery period was assigned to new farm machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) which was used in a farming business,[489] the original use of which commenced with the taxpayer after December 31, 2008, and which was placed in service before January 1, 2010.[490]

Any property (other than nonresidential real property,[491] residential rental property,[492] and trees or vines bearing fruits or nuts[493]) used in a farming business[494] is subject to the 150-percent declining balance method.[495]

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remains in effect except to the extent that the Congress has, since 1988, statutorily modified the recovery period for certain depreciable assets, effectively superseding any administrative guidance with regard to such property.

483 Under the declining balance method the depreciation rate is determined by dividing the appropriate percentage (here 150 or 200) by the appropriate recovery period. This leads to accelerated depreciation when the declining balance percentage is greater than 100. The table below illustrates depreciation for an asset with a cost of $1,000 and a seven-year recovery period under the 200-percent declining balance method, the 150-percent declining balance method, and the straight line method. (see endnote for table).

484 Revenue Procedure 87-56, Asset class 01.1, Agriculture.

485 Revenue Procedure 87-56, Asset class 01.11, Cotton ginning assets.

486 Within the meaning of section 168(i)(13). See also Revenue Procedure 87-56, Asset class 01.4, Single purpose agricultural or horticultural structures. Farm buildings that do not meet the definition of a single purpose agricultural or horticultural structure are assigned a recovery period of 20 years. Revenue Procedure 87-56, Asset class 01.3, Farm buildings except structures included in asset class 01.4.

487 IRC section 168(e)(3)(D)(i) and (ii).

488 Revenue Procedure 87-56, Asset class 00.3, Land improvements. See also, Internal Revenue Service (IRS) Publication 225, Farmer's Tax Guide (2017).

489 As defined in IRC section 263A(e)(4). See also Treasury Regulation section 1.263A-4(a)(4).

490 IRC section 168(e)(3)(B)(vii).

491 IRC section 168(b)(3)(A).

492 IRC section 168(b)(3)(B).

493 IRC section 168(b)(3)(E).

494 Within the meaning of IRC section 263A(e)(4). *See also* Treasury Regulation section 1.263A-4(a)(4).

495 IRC section 168(b)(2)(B).

Under a special accounting rule, certain taxpayers engaged in the business of farming who elect to deduct preproductive period expenditures are required to depreciate all farming assets using the alternative depreciation system (*i.e.,* using longer recovery periods and the straight line method).[496]

New Federal Law (IRC section 168)

The provision shortens the recovery period from 7 to 5 years for any machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) used in a farming business, the original use of which commences with the taxpayer and is placed in service after December 31, 2017.

The provision also repeals the required use of the 150-percent declining balance method for property used in a farming business (*i.e.,* for 3-, 5-, 7-, and 10-year property). The 150-percent declining balance method will continue to apply to any 15-year or 20-year property used in the farming business to which the straight line method does not apply, or to property for which the taxpayer elects the use of the 150-percent declining balance method.

For these purposes, the term "farming business" means a farming business as defined in IRC section 263A(e)(4). Thus, the term "farming business" means a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity (e.g., the trade or business of operating a nursery or sod farm; the raising or harvesting of trees bearing fruit, nuts, or other crops; the raising of ornamental trees (other than evergreen trees that are more than six years old at the time they are severed from their roots); and the raising, shearing, feeding, caring for, training, and management of animals).[497] A farming business includes processing activities that are normally incident to the growing, raising, or harvesting of agricultural or horticultural products.[498] A farming business does not include contract harvesting of an agricultural or horticultural commodity grown or raised by another taxpayer, or merely buying and reselling plants or animals grown or raised by another taxpayer.[499]

Effective Dates

The provision is effective for property placed in service after December 31, 2017, in taxable years ending after such date.

[496] IRC section 263A(d)(3) and (e)(2).
[497] Treasury Regulation section 1.263A-4(a)(4)(i).
[498] Treasury Regulation section 1.263A-4(a)(4)(ii).
[499] Treasury Regulation section 1.263A-4(a)(4)(i).

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

California does not conform, under the PITL, to IRC section 168(e)(3)((B)(vii),[500] relating to machinery or equipment used in a farming business. As a result, the federal modifications to the recovery period for farming machinery or equipment are not applicable.

California does not conform, under the CTL, to IRC section 168, relating to MACRS depreciation.

The CTL is in substantial conformity to the pre-1981 ADR deduction. The ADR is based on the "useful life" of depreciable property.[501] As a result, the federal modifications to the recovery period for farming machinery or equipment is not applicable.

Impact on California Revenue

Estimated Conformity Revenue Impact of Modifications of Treatment of Certain Farm Property[502] For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	- $1,300,000	- $1,000,000	- $1,800,000

Section	Section Title
13204	Applicable Recovery Period for Real Property

Background

In General

A taxpayer generally must capitalize the cost of property used in a trade or business or held for the production of income and recover such cost over time through annual deductions for depreciation or amortization.[503] Tangible property generally is depreciated under MACRS, which determines depreciation for different types of property based on an assigned applicable depreciation method, recovery period, and convention.[504]

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[500] R&TC section 17250(a)(12).
[501] R&TC section 24349.
[502] Amounts include revenue impacts for Act sections 13203 and 13205 combined.
[503] See IRC sections 263(a) and 167. However, where property is not used exclusively in a taxpayer's business, the amount eligible for a deduction must be reduced by the amount related to personal use. See, *e.g.*, IRC section 280A.
[504] IRC section 168.

Recovery Periods and Depreciation Methods

The applicable recovery period for an asset is determined in part by statute and in part by historic Treasury guidance.[505] The "type of property" of an asset is used to determine the "class life" of the asset, which in turn dictates the applicable recovery period for the asset.

The MACRS recovery periods applicable to most tangible personal property range from three to 20 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods,[506] switching to the straight line method for the first taxable year where using the straight line method with respect to the adjusted basis as of the beginning of that year yields a larger depreciation allowance. The recovery periods for most real property are 39 years for nonresidential real property and 27.5 years for residential rental property. The straight line depreciation method is required for the aforementioned real property.

Placed-In-Service Conventions

Depreciation of an asset begins when the asset is deemed to be placed in service under the applicable convention.[507] Under MACRS, nonresidential real property, residential rental property, and any railroad grading or tunnel bore generally are subject to the mid-month convention, which treats all property placed in service during any month (or disposed of during any month) as placed in service (or disposed of) on the mid-point of such month.[508] All other property generally is subject to the half-year convention, which treats all property placed in service during any taxable year (or disposed of during any taxable year) as placed in service (or disposed of) on the mid-point of such taxable year to reflect the assumption that assets are placed in service ratably throughout the year.[509] However, if substantial property is placed in service during the last three months of a taxable year, a special rule requires use of the mid-quarter convention,[510] designed to prevent the recognition of disproportionately large amounts of first-year depreciation under the half-year convention.

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[505] Exercising authority granted by Congress, the Secretary issued Revenue Procedure 87-56, 1987-2 C.B. 674, laying out the framework of recovery periods for enumerated classes of assets. The Secretary clarified and modified the list of asset classes in Revenue Procedure 88-22, 1988-1 C.B. 785.
In November 1988, Congress revoked the Secretary's authority to modify the class lives of depreciable property. Revenue Procedure 87-56, as modified, remains in effect except to the extent that the Congress has, since 1988, statutorily modified the recovery period for certain depreciable assets, effectively superseding any administrative guidance with regard to such property.

[506] Under the declining balance method the depreciation rate is determined by dividing the appropriate percentage (here 150 or 200) by the appropriate recovery period. This leads to accelerated depreciation when the declining balance percentage is greater than 100.

[507] Treasury Regulation section 1.167(a)-10(b).

[508] IRC section 168(d)(2) and (d)(4)(B).

[509] IRC section 168(d)(1) and (d)(4)(A).

[510] The mid-quarter convention treats all property placed in service (or disposed of) during any quarter as placed in service (or disposed of) on the mid-point of such quarter. IRC section 168(d)(3) and (d)(4)(C).

Depreciation of Additions or Improvements to Property

The recovery period for any addition or improvement to real or personal property begins on the later of (1) the date on which the addition or improvement is placed in service, or (2) the date on which the property with respect to which such addition or improvement is made is placed in service.[511] Any MACRS deduction for an addition or improvement to any property is to be computed in the same manner as the deduction for the underlying property would be if such property were placed in service at the same time as such addition or improvement. Thus, for example, the cost of an improvement to a building that constitutes nonresidential real property is recovered over 39 years using the straight line method and mid-month convention. Certain improvements to nonresidential real property are eligible for the additional first-year depreciation deduction if the other requirements of IRC section 168(k) are met (*i.e.,* improvements that constitute "qualified improvement property").[512]

Qualified Improvement Property

Qualified improvement property is any improvement to an interior portion of a building that is nonresidential real property if such improvement is placed in service after the date such building was first placed in service.[513] Qualified improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, or the internal structural framework of the building.

Depreciation of Leasehold Improvements

Generally, depreciation allowances for improvements made on leased property are determined under MACRS, even if the MACRS recovery period assigned to the property is longer than the term of the lease.[514] This rule applies regardless of whether the lessor or the lessee places the leasehold improvements in service. If a leasehold improvement constitutes an addition or improvement to nonresidential real property already placed in service, the improvement generally is depreciated using the straight-line method over a 39-year recovery period, beginning in the month the addition or improvement was placed in service. However, exceptions to the 39-year recovery period exist for certain qualified leasehold improvements, qualified restaurant property, and qualified retail improvement property.

Qualified Leasehold Improvement Property

IRC section 168(e)(3)(E)(iv) provides a statutory 15-year recovery period for qualified leasehold improvement property. Qualified leasehold improvement property is any improvement to an interior portion of a building that is nonresidential real property, provided certain requirements are met.[515] The improvement must be made under or pursuant to a lease either by the lessee (or

[511] IRC section 168(i)(6).
[512] IRC section 168(k)(2)(A)(i)(IV) and (k)(3). See also section 13201 of the bill (Temporary 100-percent expensing for certain business assets).
[513] IRC section 168(k)(3).
[514] IRC section 168(i)(8).
[515] IRC section 168(e)(6).

sublessee), or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or sublessee). The improvement must be placed in service more than three years after the date the building was first placed in service. Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building. If a lessor makes an improvement that qualifies as qualified leasehold improvement property, such improvement does not qualify as qualified leasehold improvement property to any subsequent owner of such improvement. An exception to the rule applies in the case of death and certain transfers of property that qualify for non-recognition treatment.

Qualified leasehold improvement property is generally recovered using the straight-line method and a half-year convention,[516] and is eligible for the additional first-year depreciation deduction if the other requirements of IRC section 168(k) are met.[517]

Qualified Restaurant Property

IRC section 168(e)(3)(E)(v) provides a statutory 15-year recovery period for qualified restaurant property. Qualified restaurant property is any IRC section 1250 property that is a building or an improvement to a building, if more than 50 percent of the building's square footage is devoted to the preparation of, and seating for on-premises consumption of, prepared meals.[518] Qualified restaurant property is recovered using the straight-line method and a half-year convention.[519] Additionally, qualified restaurant property is not eligible for the additional first-year depreciation deduction unless it also satisfies the definition of qualified improvement property.[520]

Qualified Retail Improvement Property

IRC section 168(e)(3)(E)(ix) provides a statutory 15-year recovery period for qualified retail improvement property. Qualified retail improvement property is any improvement to an interior portion of a building which is nonresidential real property if such portion is open to the general public[521] and is used in the retail trade or business of selling tangible personal property to the general public, and such improvement is placed in service more than three years after the date the building was first placed in service.[522] Qualified retail improvement property does not include any improvement for which the expenditure is attributable to the enlargement of the building, any elevator or escalator, any structural component benefiting a common area, or the internal structural framework of the building.[523] In the case of an improvement made by the owner of

[516] IRC section 168(b)(3)(G) and (d).
[517] IRC section 168(k)(2)(A)(i)(IV) and (k)(3). See section 13201 of the bill (Temporary 100-percent expensing for certain business assets).
[518] IRC section 168(e)(7).
[519] IRC section 168(b)(3)(H) and (d).
[520] IRC section 168(e)(7)(B).
[521] Improvements to portions of a building not open to the general public (*e.g.*, stock room in back of retail space) do not qualify under the provision.
[522] IRC section 168(e)(8).
[523] IRC section 168(e)(8)(C).

such improvement, the improvement is a qualified retail improvement only so long as the improvement is held by such owner.[524]

Retail establishments that qualify for the 15-year recovery period include those primarily engaged in the sale of goods. Examples of these retail establishments include, but are not limited to, grocery stores, clothing stores, hardware stores, and convenience stores. Establishments primarily engaged in providing services, such as professional services, financial services, personal services, health services, and entertainment, do not qualify. Generally, it is intended that businesses defined as a store retailer under the current North American Industry Classification System (industry subsectors 441 through 453) qualify while those in other industry classes do not qualify.[525]

Qualified retail improvement property is recovered using the straight-line method and a half-year convention,[526] and is eligible for the additional first-year depreciation deduction if the other requirements of IRC section 168(k) are met.[527]

Alternative Depreciation System

The alternative depreciation system (ADS) is required to be used for tangible property used predominantly outside the United States, certain tax-exempt use property, tax-exempt bond financed property, and certain imported property covered by an Executive order.[528] An election to use ADS is available to taxpayers for any class of property for any taxable year.[529] Under ADS, all property is depreciated using the straight line method over recovery periods which generally are equal to the class life of the property, with certain exceptions.[530] For example, nonresidential real and residential rental property have a 40-year ADS recovery period, while qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property have a 39-year ADS recovery period.[531]

<u>New Federal Law (IRC section 168)</u>

The provision shortens the ADS recovery period for residential rental property from 40 years to 30 years.

The provision eliminates the separate definitions of qualified leasehold improvement, qualified restaurant, and qualified retail improvement property, and provides a general 15-year recovery

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[524] IRC section 168(e)(8)(B). Rules similar to section 168(e)(6)(B) apply in the case of death and certain transfers of property that qualify for non-recognition treatment.
[525] Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 110th Congress* (JCS-1-09), March 2009, p. 402.
[526] IRC section 168(b)(3)(I) and (d).
[527] IRC section 168(k)(2)(A)(i)(IV) and (k)(3). See section 13301 of the bill (Temporary 100-percent expensing for certain business assets).
[528] IRC section 168(g).
[529] IRC section 168(g)(7).
[530] IRC section 168(g)(2) and (3).
[531] IRC section 168(g)(3).

period for qualified improvement property,[532] and a 20-year ADS recovery period for such property. Thus, for example, qualified improvement property placed in service after December 31, 2017, is generally depreciable over 15 years using the straight line method and half-year convention, without regard to whether the improvements are property subject to a lease, placed in service more than three years after the date the building was first placed in service, or made to a restaurant building. Restaurant building property placed in service after December 31, 2017, that does not meet the definition of qualified improvement property is depreciable over 25 years as nonresidential real property, using the straight line method and the mid-month convention.

As a conforming amendment, the provision replaces the references in IRC section 179(f) to qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property with a reference to qualified improvement property. Thus, for example, the provision allows IRC section 179 expensing for improvement property without regard to whether the improvements are property subject to a lease, placed in service more than three years after the date the building was first placed in service, or made to a restaurant building. Restaurant building property placed in service after December 31, 2017, that does not meet the definition of qualified improvement property is not eligible for IRC section 179 expensing.

The provision also requires a real property trade or business electing out of the limitation on the deduction for interest to use ADS to depreciate any of its nonresidential real property, residential rental property, and qualified improvement property.

Effective Dates

The provision is effective for property placed in service after December 31, 2017, and to taxable years beginning after December 31, 2017, for an electing real property trade or business.

California Law (R&TC sections 17201 and 24349)

California does not conform, under the PITL, to IRC section 168(e)(3),[533] relating to the definition and classification of qualified leasehold improvement, qualified restaurant, and qualified retail improvement property. As a result, the federal modifications to eliminate the separate definitions of qualified leasehold improvement, qualified restaurant, and qualified retail improvement property, and provide a general 15-year recovery period for qualified improvement property, are not applicable.

California conforms, under the PITL, to IRC section 168(g)(2), relating to the ADS recovery period for residential rental property, as of the specified date of January 1, 2015,[534] but does not conform to the federal change in the recovery period.

California does not conform, under the CTL, to IRC section 168, relating to MACRS depreciation.

[532] Described in present law section 168(k)(3).
[533] R&TC sections 17250(a)(5) and (6).
[534] R&TC section 17024.5.

The CTL is in substantial conformity to the pre-1981 ADR deduction. The ADR is based on the "useful life" of depreciable property.[535] As a result, the federal modifications to the recovery periods are not applicable.

Impact on California Revenue

Estimated Conformity Revenue Impact of Applicable Recovery Period for Real Property For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	- $700,000	- $950,000	- $1,500,000

Section	Section Title
13205	Use of Alternative Depreciation System for Electing Farming Businesses

Background

In General

A taxpayer generally must capitalize the cost of property used in a trade or business or held for the production of income and recover such cost over time through annual deductions for depreciation or amortization.[536] Tangible property generally is depreciated under MACRS, which determines depreciation for different types of property based on an assigned applicable depreciation method, recovery period, and convention.[537]

The applicable recovery period for an asset is determined in part by statute and in part by historic Treasury guidance.[538] The "type of property" of an asset is used to determine the "class life" of the asset, which in turn dictates the applicable recovery period for the asset.

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[535] R&TC section 24349.
[536] See IRC sections 263(a) and 167. However, where property is not used exclusively in a taxpayer's business, the amount eligible for a deduction must be reduced by the amount related to personal use. See, e.g., section 280A.
[537] IRC section 168.
[538] Exercising authority granted by Congress, the Secretary issued Revenue Procedure 87-56, 1987-2 C.B. 674, laying out the framework of recovery periods for enumerated classes of assets. The Secretary clarified and modified the list of asset classes in Revenue Procedure 88-22, 1988-1 C.B. 785. In November 1988, Congress revoked the Secretary's authority to modify the class lives of depreciable property. Revenue Procedure 87-56, as modified, remains in effect except to the extent that the Congress has, since 1988, statutorily modified the recovery period for certain depreciable assets, effectively superseding any administrative guidance with regard to such property.

The MACRS recovery periods applicable to most tangible personal property range from three to 20 years. The depreciation methods generally applicable to tangible personal property are the 200-percent and 150-percent declining balance methods,[539] switching to the straight line method for the first taxable year where using the straight line method with respect to the adjusted basis as of the beginning of that year yields a larger depreciation allowance. The recovery periods for most real property are 39 years for nonresidential real property and 27.5 years for residential rental property.[540] The straight line depreciation method is required for the aforementioned real property.

Property used in a farming business is assigned various recovery periods in the same manner as other business property. For example, depreciable assets used in agriculture activities that are assigned a recovery period of 7 years include machinery and equipment, grain bins, and fences (but no other land improvements), that are used in the production of crops or plants, vines, and trees; livestock; the operation of farm dairies, nurseries, greenhouses, sod farms, mushrooms cellars, cranberry bogs, apiaries, and fur farms; and the performance of agriculture, animal husbandry, and horticultural services.[541] Cotton ginning assets are also assigned a recovery period of 7 years.[542] Any single purpose agricultural or horticultural structure,[543] and any tree or vine bearing fruit or nuts are assigned a recovery period of 10 years.[544] Land improvements such as drainage facilities, paved lots, and water wells are assigned a recovery period of 15 years.[545]

A 5-year recovery period was assigned to new farm machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) which was used in a farming business,[546] the original use of which commenced with the taxpayer after December 31, 2008, and which was placed in service before January 1, 2010.[547]

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[539] Under the declining balance method the depreciation rate is determined by dividing the appropriate percentage (here 150 or 200) by the appropriate recovery period. This leads to accelerated depreciation when the declining balance percentage is greater than 100. The table below illustrates depreciation for an asset with a cost of $1,000 and a seven-year recovery period under the 200-percent declining balance method, the 150-percent declining balance method, and the straight line method. (see endnote for table).
[540] However, section 13204 of the bill (Applicable recovery period for real property) reduces the recovery period to 25 years for both nonresidential real property and residential rental property.
[541] Revenue Procedure 87-56, Asset class 01.1, Agriculture.
[542] Revenue Procedure 87-56, Asset class 01.11, Cotton ginning assets.
[543] Within the meaning of section 168(i)(13). See also Revenue Procedure 87-56, Asset class 01.4, Single purpose agricultural or horticultural structures. Farm buildings that do not meet the definition of a single purpose agricultural or horticultural structure are assigned a recovery period of 20 years. Revenue Procedure 87-56, Asset class 01.3, Farm buildings except structures included in asset class 01.4.
[544] IRC section 168(e)(3)(D)(i) and (ii).
[545] Revenue Procedure 87-56, Asset class 00.3, Land improvements. See also, IRS Publication 225, Farmer's Tax Guide (2017).
[546] As defined in section 263A(e)(4).
[547] IRC section 168(e)(3)(B)(vii). However, section 13203 of the bill (Modifications of treatment of certain farm property) also shortens the recovery period from 7 to 5 years for any machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) which is used in a farming business, the original use of which commences with the taxpayer and is placed in service after December 31, 2017.

Any property (other than nonresidential real property,[548] residential rental property,[549] and trees or vines bearing fruits or nuts[550]) used in a farming business[551] is subject to the 150-percent declining balance method.[552]

Alternative Depreciation System

The ADS is required to be used for tangible property used predominantly outside the United States, certain tax-exempt use property, tax-exempt bond financed property, and certain imported property covered by an Executive order.[553] An election to use ADS is available to taxpayers for any class of property for any taxable year.[554] Under ADS, all property is depreciated using the straight line method over recovery periods which generally are equal to the class life of the property, with certain exceptions.[555] For example, any single purpose agricultural or horticultural structure has a 15-year ADS recovery period,[556] while any tree or vine bearing fruit or nuts has a 20-year ADS recovery period.[557] Similarly, land improvements such as drainage facilities, paved lots, and water wells have an ADS recovery period of 20 years.[558]

Under a special accounting rule, certain taxpayers engaged in the business of farming who elect to deduct preproductive period expenditures under the uniform capitalization rules are required to depreciate all farming assets using ADS.[559]

<u>New Federal Law (IRC section 168)</u>

The provision requires an electing farming business, i.e., a farming business electing out of the limitation on the deduction for interest, to use ADS to depreciate any property with a recovery period of 10 years or more (e.g., property such as single purpose agricultural or horticultural structures, trees or vines bearing fruit or nuts, farm buildings, and certain land improvements).

<u>Effective Dates</u>

The provision is effective for taxable years beginning after December 31, 2017.

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548 IRC section 168(b)(3)(A).
549 IRC section 168(b)(3)(B).
550 IRC section 168(b)(3)(E).
551 Within the meaning of section 263A(e)(4).
552 IRC section 168(b)(2)(B). However, section 13203 of the bill (Modifications of treatment of certain farm property) repeals the required use of the 150-percent declining balance method for property used in a farming business (i.e., for 3-, 5-, 7-, and 10-year property). The 150-percent declining balance method will continue to apply to any 15-year or 20-year property used in the farming business to which the straight line method does not apply, or to property for which the taxpayer elects the use of the 150-percent declining balance method.
553 IRC section 168(g).
554 IRC section 168(g)(7).
555 IRC section 168(g)(2) and (3).
556 IRC section 168(g)(3)(B). Farm buildings that do not meet the definition of a single purpose agricultural or horticultural structure have an ADS recovery period of 25 years. Revenue Procedure 87-56, Asset class 01.3, Farm buildings except structures included in asset class 01.4.
557 IRC section 168(g)(3)(B).
558 Revenue Procedure 87-56, Asset class 00.3, Land improvements.
559 IRC section 263A(d)(3) and (e)(2).

California Law (R&TC sections 17201 and 24349)

California conforms, under the PITL, to the MACRS under IRC section 168, as of the specified date of January 1, 2015,[560] with modifications,[561] but does not conform to the federal change requiring electing farming business to use ADS to depreciate certain recovery property.

California does not conform, under the CTL, to IRC section 168, relating to MACRS depreciation.

The CTL is in substantial conformity to the pre-1981 ADR deduction. The ADR is based on the "useful life" of depreciable property.[562] As a result, the federal modifications requiring electing farming business to use ADS to depreciate certain recovery property are not applicable.

Impact on California Revenue

Estimated Conformity Revenue Impact of Use of Alternative Depreciation System for Electing Farming Businesses For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
See above Section 13203	See above Section 13203	See above Section 13203	See above Section 13203

Section	Section Title
13206	Amortization of Research and Experimental Expenditures

Background

Business expenses associated with the development or creation of an asset having a useful life extending beyond the current year generally must be capitalized and depreciated over such useful life.[563] Taxpayers, however, may elect to deduct currently the amount of certain reasonable research or experimentation expenditures paid or incurred in connection with a trade or business.[564] Taxpayers may choose to forgo a current deduction, capitalize their research expenditures, and recover them ratably over the useful life of the research, but in no case over a period of less than 60 months.[565] Taxpayers, alternatively, may elect to amortize their research

[560] R&TC section 17024.5.
[561] R&TC section 17250.
[562] R&TC section 24349.
[563] IRC sections 167 and 263(a).
[564] IRC sections 174(a) and (e).
[565] IRC section 174(b). Taxpayers generating significant short-term losses often choose to defer the deduction for their research and experimentation expenditures under this section. Additionally, IRC section 174 amounts are

expenditures over a period of 10 years.[566] Research and experimental expenditures deductible under IRC section 174 are not subject to capitalization under either IRC section 263(a)[567] or IRC section 263A.[568]

Amounts defined as research or experimental expenditures under IRC section 174 generally include all costs incurred in the experimental or laboratory sense related to the development or improvement of a product.[569] In particular, qualifying costs are those incurred for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product.[570] Uncertainty exists when information available to the taxpayer is not sufficient to ascertain the capability or method for developing, improving, and/or appropriately designing the product.[571] The determination of whether expenditures qualify as deductible research expenses depends on the nature of the activity to which the costs relate, not the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents. Examples of qualifying costs include salaries for those engaged in research or experimentation efforts, amounts incurred to operate and maintain research facilities (*e.g.*, utilities, depreciation, rent), and expenditures for materials and supplies used and consumed in the course of research or experimentation (including amounts incurred in conducting trials). [572] In addition, under administrative guidance, the costs of developing computer software have been accorded treatment similar to research expenditures.[573]

Research or experimental expenditures under IRC section 174 do not include expenditures for quality control testing; efficiency surveys; management studies; consumer surveys; advertising or promotions; the acquisition of another's patent, model, production or process; or research in connection with literary, historical, or similar projects.[574] For purposes of IRC section 174, quality control testing means testing to determine whether particular units of materials or products

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excluded from the definition of "start-up expenditures" under IRC section 195 (IRC section 195 generally provides that start-up expenditures in excess of $5,000 either are not deductible or are amortizable over a period of not less than 180 months once an active trade or business begins). So as not to generate significant losses before beginning their trade or business, a taxpayer may choose to defer the deduction and amortize its IRC section 174 costs beginning with the month in which the taxpayer first realizes benefits from the expenditures.

566 IRC sections 174(f)(2) and 59(e). This special 10-year election is available to mitigate the effect of the alternative minimum tax adjustment for research expenditures set forth in IRC section 56(b)(2). Taxpayers with significant losses also may elect to amortize their otherwise deductible research and experimentation expenditures to reduce amounts that could be subject to expiration under the net operating loss carryforward regime.

567 IRC section 263(a)(1)(B).

568 IRC section 263A(c)(2).

569 Treasury Regulation section 1.174-2(a)(1) and (2). Product is defined to include any pilot model, process, formula, invention, technique, patent, or similar property, and includes products to be used by the taxpayer in its trade or business as well as products to be held for sale, lease, or license. Treasury Regulation section 1.174-2(a)(11), Example 10, provides an example of new process development costs eligible for section 174 treatment.

570 Treasury Regulation section 1.174-2(a)(1).

571 *Ibid.*

572 See Treasury Regulation section 1.174-4(c). The definition of research and experimental expenditures also includes the costs of obtaining a patent, such as attorneys' fees incurred in making and perfecting a patent. Treasury Regulation section 1.174-2(a)(1).

573 Revenue Procedure 2000-50, 2000-2 C.B. 601.

574 Treasury Regulation section 1.174-2(a)(6).

conform to specified parameters, but does not include testing to determine if the design of the product is appropriate.[575]

Generally, no current deduction under IRC section 174 is allowable for expenditures for the acquisition or improvement of land or of depreciable or depletable property used in connection with any research or experimentation.[576] In addition, no current deduction is allowed for research expenses incurred for the purpose of ascertaining the existence, location, extent, or quality of any deposit of ore or other mineral, including oil and gas.[577]

New Federal Law (IRC section 174)

Under the provision, amounts defined as specified research or experimental expenditures are required to be capitalized and amortized ratably over a five-year period, beginning with the midpoint of the taxable year in which the specified research or experimental expenditures were paid or incurred. Specified research or experimental expenditures which are attributable to research that is conducted outside of the United States[578] are required to be capitalized and amortized ratably over a period of 15 years, beginning with the midpoint of the taxable year in which such expenditures were paid or incurred. Specified research or experimental expenditures subject to capitalization include expenditures for software development.

Specified research or experimental expenditures do not include expenditures for land or for depreciable or depletable property used in connection with the research or experimentation, but do include the depreciation and depletion allowances of such property. Also excluded are exploration expenditures incurred for ore or other minerals (including oil and gas).

In the case of retired, abandoned, or disposed property with respect to which specified research or experimental expenditures are paid or incurred, any remaining basis may not be recovered in the year of retirement, abandonment, or disposal, but instead must continue to be amortized over the remaining amortization period.

The provision is treated as a change in the taxpayer's method of accounting for purposes of IRC section 481, initiated by the taxpayer, and made with the consent of the Secretary. However, the provision is applied on a cutoff basis to research or experimental expenditures paid or incurred in taxable years beginning after December 31, 2021, (hence there is no adjustment under IRC section 481(a) for research or experimental expenditures paid or incurred in taxable years beginning before January 1, 2026).

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[575] Treasury Regulation section 1.174-2(a)(7).
[576] IRC section 174(c).
[577] IRC section 174(d). Special rules apply with respect to geological and geophysical costs (IRC section 167(h)), qualified tertiary injectant expenses (IRC section 193), intangible drilling costs (IRC sections 263(c) and 291(b)), and mining exploration and development costs (IRC sections 616 and 617).
[578] For this purpose, the term “United States” includes the United States, the Commonwealth of Puerto Rico, and any possession of the United States.

As part of the repeal of the alternative minimum tax, taxpayers may no longer elect to amortize their research or experimental expenditures over a period of 10 years.

Effective Dates

The provision applies to amounts paid or incurred in taxable years beginning after December 31, 2021.

California Law (R&TC sections 17201 and 24365)

California conforms, under the PITL and the CTL, to IRC section 174, relating to research and experimental expenditures, as of the specified date of January 1, 2015,[579] with modifications under the CTL,[580] but does not conform to the federal changes relating to the amortization of research and experimental expenditures.

Impact on California Revenue

Estimated Conformity Revenue Impact of Amortization of Research and Experimental Expenditures[581] For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	N/A	N/A	N/A

Section	Section Title
13207	Expensing of Certain Costs of Replanting Citrus Plants Lost by Reason of Casualty

Background

In General

The UNICAP rules, which were enacted as part of the Tax Reform Act of 1986,[582] require certain direct and indirect costs allocable to real or tangible personal property produced by the taxpayer to be either capitalized into the basis of such property or included in inventory, as applicable.[583] For real or personal property acquired by the taxpayer for resale, IRC section 263A generally

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[579] R&TC section 17024.5 and 23051.5.
[580] R&TC section 24365.
[581] The impact to the general fund would be a revenue gain for taxable years beginning on or after January 1, 2022.
[582] Section 803(a) of Public Law Number 99-514 (1986).
[583] IRC section 263A.

requires certain direct and indirect costs allocable to such property to be either capitalized into the basis of such property or included in inventory, as applicable.

IRC section 263A generally requires the capitalization of the direct and indirect costs allocable to the production of any property in a farming business, including animals and plants without regard to the length of their preproductive period.[584] The costs of a plant generally required to be capitalized under IRC section 263(a) include preparatory costs incurred so that the plant's growing process may begin, such as the acquisition costs of the seed, seedling, or plant. Under IRC section 263A, the costs of producing a plant generally required to be capitalized also include the preproductive period costs of planting, cultivating, maintaining, and developing the plant during the preproductive period.[585] Preproductive period costs may include management, irrigation, pruning, soil and water conservation, fertilizing, frost protection, spraying, harvesting, storage and handling, upkeep, electricity, tax depreciation and repairs on buildings and equipment used in raising the plants, farm overhead, taxes, and interest, as applicable.[586]

Special Rules for Plant Farmers

IRC section 263A provides an exception to the general capitalization requirements for taxpayers who raise, harvest, or grow trees.[587] Under this exception, IRC section 263A does not apply to trees raised, harvested, or grown by the taxpayer (other than trees bearing fruit, nuts, or other crops, or ornamental trees) and any real property underlying such trees. Similarly, the UNICAP rules do not apply to any plant having a preproductive period of two years or less, which is produced by a taxpayer in a farming business (unless the taxpayer is required to use an accrual method of accounting under IRC section 447 or 448(a)(3)).[588] Hence, in general, the UNICAP rules apply to the production of plants that have a preproductive period of more than two years, and to taxpayers required to use an accrual method of accounting.

Plant farmers otherwise required to capitalize preproductive period costs may elect to deduct such costs currently, provided the alternative depreciation system described in IRC section 168(g)(2) is used on all farm assets and the preproductive period costs are recaptured upon disposition of the product.[589] The election is not available to taxpayers required to use the accrual method of accounting. Moreover, the election is not available with respect to certain costs attributable to planting, cultivating, maintaining, or developing citrus or almond groves.

IRC section 263A does not apply to costs incurred in replanting edible crops for human consumption following loss or damage due to freezing temperatures, disease, drought, pests, or casualty.[590] The same type of crop as the lost or damaged crop must be replanted. However, the

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[584] Treasury Regulation section 1.263A-4(b)(1).
[585] Treasury Regulation section 1.263A-4(b)(1)(i).
[586] Ibid.
[587] IRC section 263A(c)(5).
[588] IRC section 263A(d).
[589] IRC section 263A(d)(3), (e)(1), and (e)(2).
[590] IRC section 263A(d)(2). Such replanting costs generally include costs attributable to the replanting, cultivating, maintaining, and developing of the plants that were lost or damaged that are incurred during the preproductive period. Treasury Regulation section 1.263A-4(e)(1). The acquisition costs of the replacement trees or seedlings must

exception to capitalization still applies if the replanting occurs on a parcel of land other than the land on which the damage occurred, provided the acreage of the new land does not exceed that of the land to which the damage occurred and the new land is located in the United States. This exception may also apply to costs incurred by persons other than the taxpayer who incurred the loss or damage, provided (1) the taxpayer who incurred the loss or damage retains an equity interest of more than 50 percent in the property on which the loss or damage occurred at all times during the taxable year in which the replanting costs are paid or incurred, and (2) the person holding a minority equity interest and claiming the deduction materially participates in the planting, maintenance, cultivation, or development of the property during the taxable year in which the replanting costs are paid or incurred.[591]

New Federal Law (IRC section 263A)

The provision modifies the special rule for costs incurred by persons other than the taxpayer in connection with replanting an edible crop for human consumption following loss or damage due to casualty. Under the provision, with respect to replanting costs paid or incurred after the date of enactment, but no later than a date which is ten years after such date of enactment, for citrus plants lost or damaged due to casualty, such replanting costs may also be deducted by a person other than the taxpayer if (1) the taxpayer has an equity interest of not less than 50 percent in the replanted citrus plants at all times during the taxable year in which the replanting costs are paid or incurred and such other person holds any part of the remaining equity interest, or (2) such other person acquires all of the taxpayer's equity interest in the land on which the lost or damaged citrus plants were located at the time of such loss or damage, and the replanting is on such land.

Effective Dates

The provision is effective for costs paid or incurred after the date of enactment, December 22, 2017.

California Law (R&TC sections 17201 and 24422.3)

California conforms, under the PITL and CTL, to the federal rules for capitalization and inclusion in inventory for costs of certain expenses, also known as the UNICAP rules, under IRC section 263A, as of the "specified date" of January 1, 2015,[592] but does not conform to modifications related to the expensing of certain costs of replanting citrus plants lost by reason of casualty.

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still be capitalized under section 263(a) (see, *e.g.*, T.D. 8897, 65 FR 50638, Treasury Regulation section 1.263A-4(e)(3), Examples 1-3, and TAM 9547002 (July 18, 1995)), potentially subject to the special bonus depreciation deduction in the year of planting under section 168(k)(5).

[591] IRC section 263A(d)(2)(B). Material participation for this purpose is determined in a similar manner as under section 2032A(e)(6) (relating to qualified use valuation of farm property upon death of the taxpayer).

[592] R&TC section 17024.5 and 23051.5.

Impact on California Revenue

Estimated Conformity Revenue Impact of Expensing of Certain Costs of Replanting Citrus Plants Lost by Reason of Casualty For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	- $400,000	- $200,000	- $200,000

Subpart B—Accounting Methods

Section	Section Title
13221	Certain Special Rules for Taxable Year of Inclusion

Background

In General

Under IRC section 61(a), gross income generally includes all income from whatever source derived, except as otherwise provided in Subtitle A of the Code. Thus, gross income generally includes income realized in any form, whether in money, property, or services, except to the extent provided in other sections of the Code.[593] Once it is determined that an item of gross income is clearly realized for Federal income tax purposes, IRC section 451 and the regulations thereunder provide the general rules as to the timing of when such item is to be included in gross income.[594]

A taxpayer generally is required to include an item in gross income no later than the time of its actual or constructive receipt, unless the item properly is accounted for in a different period under the taxpayer's method of accounting.[595] If a taxpayer has an unrestricted right to demand the payment of an amount, the taxpayer is in constructive receipt of that amount, whether or not the taxpayer makes the demand and actually receives the payment.[596]

In general, for a cash basis taxpayer, an amount is included in gross income when actually or constructively received. For an accrual basis taxpayer, an amount is included in gross income when all the events have occurred that fix the right to receive such income and the amount

[593] Treasury Regulation section 1.61-1.
[594] Treasury Regulation section 1.61-1(b)(3).
[595] IRC section 451(a).
[596] See Treasury Regulation section 1.451-2.

thereof can be determined with reasonable accuracy (*i.e.*, when the ‘‘all events test" is met), unless an exception permits deferral or exclusion, or a special method of accounting applies.[597]

A number of exceptions that exist to permit deferral of gross income relate to advance payments. An advance payment is when a taxpayer receives payment before the taxpayer provides goods or services to its customer. The exceptions often allow tax deferral to mirror financial accounting deferral (*e.g.*, income is recognized as the goods are provided or the services are performed).[598]

Interest Income

A taxpayer generally must include in gross income the amount of interest received or accrued within the taxable year on indebtedness held by the taxpayer.[599]

Original Issue Discount

The holder of a debt instrument with original issue discount (OID) generally accrues and includes the OID in gross income as interest over the term of the instrument, regardless of when the stated interest (if any) is paid.[600]

The amount of OID with respect to a debt instrument is the excess of the stated redemption price at maturity over the issue price of the debt instrument.[601] The stated redemption price at maturity is the sum of all payments provided by the debt instrument other than qualified stated interest payments.[602] The holder includes in gross income an amount equal to the sum of the daily portions of the OID for each day during the taxable year the holder held such debt instrument. The daily portion is determined by allocating to each day in any accrual period its ratable portion of the increase during such accrual period in the adjusted issue price of the debt instrument.[603] The adjustment to the issue price is determined by multiplying the adjusted issue price (*i.e.*, the issue price increased by adjustments prior to the accrual period) by the instrument's yield to maturity, and then subtracting the interest payable during the accrual period. Thus, to compute the amount of OID and the portion of OID allocable to a period, the stated redemption price at maturity and the term must be known. Issuers of OID instruments accrue and deduct the amount of OID as interest expense in the same manner as the holder.[604]

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[597] See Treasury Regulation sections 1.446-1(c)(1)(ii) and 1.451-1(a).
[598] For examples of provisions permitting deferral of advance payments, see Treasury Regulation section 1.451-5 and Revenue Procedure 2004-34, 2004-1 C.B. 991, as modified and clarified by Revenue Procedure 2011-18, 2011-5 I.R.B. 443, and Revenue Procedure 2013-29, 2013-33 I.R.B. 141.
[599] IRC sections 61(a)(4) and 451.
[600] IRC section 1272.
[601] IRC section 1273(a)(1).
[602] IRC section 1273(a)(2) and Treasury Regulation section 1.1273-1(b).
[603] IRC section 1272(a)(1) and (3).
[604] IRC section 163(e).

Debt Instruments Subject to Acceleration

Special rules for determining the amount of OID allocated to a period apply to certain instruments that may be subject to prepayment. If a borrower can reduce the yield on a debt by exercising a prepayment option, the OID rules assume that the borrower will prepay the debt.[605] In addition, in the case of (1) any regular interest in a real estate mortgage investment conduit (REMIC) or qualified mortgages held by a REMIC or (2) any other debt instrument if payments under the instrument may be accelerated by reason of prepayments of other obligations securing the instrument, the daily portions of the OID on such debt instruments are determined by taking into account an assumption regarding the prepayment of principal for such instruments.[606]

The Taxpayer Relief Act of 1997[607] extended these rules to any pool of debt instruments the payments on which may be accelerated by reason of prepayments.[608] Thus, if a taxpayer holds a pool of credit card receivables that require interest to be paid only if the borrowers do not pay their accounts by a specified date ("grace-period interest"), the taxpayer is required to accrue interest or OID on such pool based upon a reasonable assumption regarding the timing of the payments of the accounts in the pool. Under these rules, certain amounts (other than grace-period interest) related to credit card transactions, such as late-payment fees,[609] cash-advance fees,[610] and interchange fees,[611] have been determined to create OID or increase the amount of OID on the pool of credit card receivables to which the amounts relate.[612]

<u>New Federal Law (IRC section 451)</u>

The provision revises the rules associated with the timing of the recognition of income.[613] Specifically, the provision requires an accrual method taxpayer subject to the all events test for an item of gross income to recognize such income no later than the taxable year in which such

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[605] Treasury Regulation section 1.1272-1(c)(5).
[606] IRC section 1272(a)(6).
[607] Public Law Number 105-34, section 1004(a).
[608] IRC section 1272(a)(6)(C)(iii).
[609] Revenue Procedure 2004-33, 2004-1 C.B. 989.
[610] Revenue Procedure 2005-47, 2005-2 C.B. 269.
[611] *Capital One Financial Corp. and Subsidiaries v. Commissioner*, 133 T.C. No. 8 (2009); IRS Chief Counsel Notice CC-2010-018, September 27, 2010.
[612] See also Revenue Procedure 2013-26, 2013-22 I.R.B. 1160, for a safe harbor method of accounting for OID on a pool of credit card receivables for purposes of section 1272(a)(6).
[613] The provision does not revise the rules associated with when an item is realized for Federal income tax purposes and, accordingly, does not require the recognition of income in situations where the Federal income tax realization event has not yet occurred. For example, the provision does not require the recharacterization of a transaction from sale to lease, or vice versa, to conform to how the transaction is reported in the taxpayer's applicable financial statement. Similarly, the provision does not require the recognition of gain or loss from securities that are marked to market for financial reporting purposes if the gain or loss from such investments is not realized for Federal income tax purposes until such time that the taxpayer sells or otherwise disposes of the investment. As a further example, income from investments in corporations or partnerships that are accounted for under the equity method for financial reporting purposes will not result in the recognition of income for Federal income tax purposes until such time that the Federal income tax realization even has occurred (*e.g.*, when the taxpayer receives a dividend from the corporation in which it owns less than a controlling interest or when the taxpayer receives its allocable share of income, deductions, gains, and losses on its Schedule K-1 from the partnership).

income is taken into account as revenue in an applicable financial statement[614] or another financial statement under rules specified by the Secretary, but provides an exception for taxpayers without an applicable or other specified financial statement.[615] In the case of a contract which contains multiple performance obligations, the provision allows the taxpayer to allocate the transaction price in accordance with the allocation made in the taxpayer's applicable financial statement.

In addition, the provision directs accrual method taxpayers with an applicable financial statement to apply the income recognition rules under IRC section 451 before applying the special rules under part V of subchapter P, which, in addition to the OID rules, also includes rules regarding the treatment of market discount on bonds, discounts on short-term obligations, OID on tax-exempt bonds, and stripped bonds and stripped coupons.[616] Thus, for example, to the extent amounts are included in revenue for financial statement purposes when received (*e.g.*, late-payment fees, cash-advance fees, or interchange fees), such amounts generally are includable in income at such time in accordance with the general recognition principles under IRC section 451. The provision provides an exception for any item of gross income in connection with a mortgage servicing contract. Thus, under the provision, income from mortgage servicing rights will continue to be recognized in accordance with the present law rules for such items of gross income (*i.e.*, “normal” mortgage servicing rights will be included in income upon the earlier of earned or received under

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[614] For purposes of the provision, the term ‘‘applicable financial statement” means: (A) a financial statement which is certified as being prepared in accordance with generally accepted accounting principles and which is (i) a 10-K (or successor form), or annual statement to shareholders, required to be filed by the taxpayer with the United States Securities and Exchange Commission (“SEC”), (ii) an audited financial statement of the taxpayer which is used for (I) credit purposes, (II) reporting to shareholders, partners, or other proprietors, or to beneficiaries, or (III) any other substantial nontax purpose, but only if there is no statement of the taxpayer described in clause (i), or (iii) filed by the taxpayer with any other Federal agency for purposes other than Federal tax purposes, but only if there is no statement of the taxpayer described in clause (i) or (ii); (B) a financial statement which is made on the basis of international financial reporting standards and is filed by the taxpayer with an agency of a foreign government which is equivalent to the SEC and which has reporting standards not less stringent than the standards required by such Commission, but only if there is no statement of the taxpayer described in subparagraph (A); or (C) a financial statement filed by the taxpayer with any other regulatory or governmental body specified by the Secretary, but only if there is no statement of the taxpayer described in subparagraph (A) or (B). If the financial results of a taxpayer are reported on the applicable financial statement for a group of entities, such statement is treated as the applicable financial statement of the taxpayer.

[615] The Committee intends that the provision apply to items of gross income for which the timing of income inclusion is determined using the all events test under present law. Under the provision, an accrual method taxpayer with an applicable financial statement will include an item in income under IRC section 451 upon the earlier of when the all events test is met or when the taxpayer includes such item in revenue in an applicable financial statement. For example, under the provision, any unbilled receivables for partially performed services must be recognized to the extent the amounts are taken into income for financial statement purposes. However, accrual method taxpayers without an applicable or other specified financial statement will continue to determine income inclusion under the all events test, unless an exception permits deferral or exclusion. See IRC section 451(a) and Treasury Regulation section 1.451-1(a). The Committee intends that the financial statement conformity requirement added to IRC section 451 not be construed as preventing the use of special methods of accounting provided elsewhere in the Code, other than part V of subchapter P (special rules for bonds and other debt instruments) excluding items of gross income in connection with a mortgage servicing contract. For example, it does not preclude the use of the installment method under IRC section 453 or the use of long-term contract methods under IRC section 460. See Treasury Regulation section 1.446-1(c)(1)(iii).

[616] IRC sections 1271-1288.

the all events test of IRC section 451 (*i.e.*, not averaged over the life of the mortgage),[617] and "excess" mortgage servicing rights will be treated as stripped coupons under IRC section 1286 and therefore subject to the original issue discount rules.)[618]

The provision also codifies the current deferral method of accounting for advance payments for goods, services, and other specified items provided by the IRS under Revenue Procedure 2004-34.[619] That is, the provision allows accrual method taxpayers to elect[620] to defer the inclusion of income associated with certain advance payments to the end of the tax year following the tax year of receipt if such income also is deferred for financial statement purposes.[621] In the case of advance payments received for a combination of services, goods, or other specified items, the provision allows the taxpayer to allocate the transaction price in accordance with the allocation made in the taxpayer's applicable financial statement. The provision requires the inclusion in gross income of a deferred advance payment if the taxpayer ceases to exist.

The application of these rules is a change in the taxpayer's method of accounting for purposes of IRC section 481. In the case of any taxpayer required by this provision to change its method of accounting for its first taxable year beginning after December 31, 2017, such change is treated as initiated by the taxpayer and made with the consent of the Secretary. In the case of income from a debt instrument having OID, the related IRC section 481(a) adjustment is taken into account over six taxable years.

<u>Effective Dates</u>

The provision generally applies to taxable years beginning after December 31, 2017. In the case of income from a debt instrument having OID, the provision applies to taxable years beginning after December 31, 2018.

<u>California Law (R&TC sections 17551, 17559, 24661, 24661.5, and 24661.6)</u>

California generally conforms, under the PITL and CTL, to the federal law providing general rules for the taxable year of inclusion under IRC section 451, as of the "specified date" of January 1, 2015,[622] but does not conform to federal modifications to the rules associated with the timing of the recognition of income.

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617 See Revenue Ruling 70-142, 1970-2 C.B. 115.
618 See Revenue Ruling 91-46, 1991-2, C.B. 358, and Revenue Procedure 91-50, 1991-2 C.B. 778.
619 2004-1 C.B. 991, as modified and clarified by Revenue Procedure 2011-18, 2011-5 I.R.B. 443, and Revenue Procedure 2013-29, 2013-33 I.R.B. 141.
620 The election shall be made at such time, in such form and manner, and with respect to such categories of advance payments as the Secretary may provide. For these purposes, the recognition of income under such election is treated as a method of accounting.
621 Thus, the provision is intended to override any deferral method provided by Treasury Regulation section 1.451-5 for advance payments received for goods.
622 R&TC section 17024.5 and 23051.5.

Impact on California Revenue

Estimated Conformity Revenue Impact of Certain Special Rules for Taxable Year of Inclusion For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	$100,000,000	$90,000,000	$80,000,000

Part IV – Business-Related Exclusions and Deductions

Section	Section Title
13301	Limitation on Deduction for Interest

Background

Interest Deduction

Interest paid or accrued by a business generally is deductible in the computation of taxable income subject to a number of limitations.[623]

Interest is generally deducted by a taxpayer as it is paid or accrued, depending on the taxpayer's method of accounting. For all taxpayers, if an obligation is issued with OID, a deduction for interest is allowable over the life of the obligation on a yield to maturity basis.[624] Generally, OID arises where interest on a debt instrument is not calculated based on a qualified rate and required to be paid at least annually.

Investment Interest Expense

In the case of a taxpayer other than a corporation, the deduction for interest on indebtedness that is allocable to property held for investment ("investment interest") is limited to the taxpayer's net

[623] IRC section 163(a). In addition to the limitations discussed herein, other limitations include: denial of the deduction for the disqualified portion of the original issue discount on an applicable high yield discount obligation (IRC section 163(e)(5)), denial of deduction for interest on certain obligations not in registered form (IRC section 163(f)), reduction of the deduction for interest on indebtedness with respect to which a mortgage credit certificate has been issued under section 25 (IRC section 163(g)), disallowance of deduction for personal interest (IRC section 163(h)), disallowance of deduction for interest on debt with respect to certain life insurance contracts (IRC section 264), and disallowance of deduction for interest relating to tax-exempt income (IRC section 265). Interest may also be subject to capitalization. See, *e.g.*, sections 263A(f) and 461(g).
[624] IRC section 163(e). But see IRC section 267 (dealing in part with interest paid to a related or foreign party).

investment income for the taxable year.[625] Disallowed investment interest is carried forward to the next taxable year.

Net investment income is investment income net of investment expenses. Investment income generally consists of gross income from property held for investment, and investment expense includes all deductions directly connected with the production of investment income (*e.g.*, deductions for investment management fees) other than deductions for interest.

The two-percent floor on miscellaneous itemized deductions allows taxpayers to deduct investment expenses connected with investment income only to the extent such deductions exceed two percent of the taxpayer's AGI.[626] Miscellaneous itemized deductions[627] that are not investment expenses are disallowed first before any investment expenses are disallowed.[628]

Earnings Stripping

IRC section 163(j) may disallow a deduction for disqualified interest paid or accrued by a corporation in a taxable year if two threshold tests are satisfied: the payor's debt-to-equity ratio exceeds 1.5 to 1.0 (the safe harbor ratio) and the payor's net interest expense exceeds 50 percent of its adjusted taxable income (generally, taxable income computed without regard to deductions for net interest expense, net operating losses, domestic production activities under IRC section 199, depreciation, amortization, and depletion). Disqualified interest includes interest paid or accrued to: (1) related parties when no Federal income tax is imposed with respect to such interest;[629] (2) unrelated parties in certain instances in which a related party guarantees the debt; or (3) to a real estate investment trust (REIT) by a taxable REIT subsidiary of that trust.[630] Interest amounts disallowed under these rules can be carried forward indefinitely.[631] In addition, any excess limitation (*i.e.*, the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years.[632]

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[625] IRC section 163(d).
[626] IRC section 67(a).
[627] Miscellaneous itemized deductions include itemized deductions of individuals other than certain specific itemized deductions. IRC section 67(b). Miscellaneous itemized deductions generally include, for example, investment management fees and certain employee business expenses, but specifically do not include, for example, interest, taxes, casualty and theft losses, charitable contributions, medical expenses, or other listed itemized deductions.
[628] H.R. Rep. No. 841, 99th Cong., 2d Sess., p. II-154, Sept. 18, 1986 (Conf. Rep.) ("In computing the amount of expenses that exceed the 2-percent floor, expenses that are not investment expenses are intended to be disallowed before any investment expenses are disallowed.").
[629] If a tax treaty reduces the rate of tax on interest paid or accrued by the taxpayer, the interest is treated as interest on which no Federal income tax is imposed to the extent of the same proportion of such interest as the rate of tax imposed without regard to the treaty, reduced by the rate of tax imposed by the treaty, bears to the rate of tax imposed without regard to the treaty. IRC section 163(j)(5)(B).
[630] IRC section 163(j)(3).
[631] IRC section 163(j)(1)(B).
[632] IRC section 163(j)(2)(B)(ii).

New Federal Law (IRC sections 163, 381, and 382)

In General

In the case of any taxpayer for any taxable year, the deduction for business interest is limited to the sum of (1) business interest income; (2) 30 percent of the adjusted taxable income of the taxpayer for the taxable year; and (3) the floor plan financing interest of the taxpayer for the taxable year. The amount of any business interest not allowed as a deduction for any taxable year may be carried forward for up to five years beyond the year in which the business interest was paid or accrued, treating business interest as allowed as a deduction on a first-in, first-out basis. The limitation applies at the taxpayer level. In the case of a group of affiliated corporations that file a consolidated return, the limitation applies at the consolidated tax return filing level.

Business interest means any interest paid or accrued on indebtedness properly allocable to a trade or business. Any amount treated as interest for purposes of the IRC is interest for purposes of the provision. Business interest income means the amount of interest includible in the gross income of the taxpayer for the taxable year which is properly allocable to a trade or business. Business interest does not include investment interest, and business interest income does not include investment income, within the meaning of IRC section 163(d).[633]

Adjusted taxable income means the taxable income of the taxpayer computed without regard to (1) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business; (2) any business interest or business interest income; (3) the amount of any net operating loss deduction; and (4) for taxable years beginning after December 31, 2017, and before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion.[634] The Secretary may provide other adjustments to the computation of adjusted taxable income.

Floor plan financing interest means interest paid or accrued on floor plan financing indebtedness. Floor plan financing indebtedness means indebtedness used to finance the acquisition or lease of motor vehicles held for sale to retail customers and secured by the inventory so acquired. A motor vehicle means any self-propelled vehicle designed for transporting persons or property on a public street, highway, or road, a boat, farm machinery or equipment, or construction machinery or equipment.

By including business interest income and floor plan financing interest in the limitation, the rule operates to allow floor plan financing interest to be fully deductible and to limit the deduction for net interest expense (less floor plan financing interest) to 30 percent of adjusted taxable income. That is, a deduction for business interest is permitted to the full extent of business interest income and any floor plan financing interest. To the extent that business interest exceeds business interest income and floor plan financing interest, the deduction for the net interest expense is limited to 30 percent of adjusted taxable income.

[633] IRC section 163(d) applies in the case of a taxpayer other than a corporation. Thus, a corporation has neither investment interest nor investment income within the meaning of IRC section 163(d). Thus, interest income and interest expense of a corporation is properly allocable to a trade or business, unless such trade or business is otherwise explicitly excluded from the application of the provision.
[634] Any deduction allowable for depreciation, amortization, or depletion includes any deduction allowable for any amount treated as depreciation, amortization, or depletion under present law.

It is generally intended that, similar to present law, IRC section 163(j) apply after the application of provisions that subject interest to deferral, capitalization, or other limitation. Thus, IRC section 163(j) applies to interest deductions that are deferred, for example under IRC section 163(e) or IRC section 267(a)(3)(B), in the taxable year to which such deductions are deferred. IRC section 163(j) applies after IRC section 263A is applied to capitalize interest and after, for example, IRC section 265 or IRC section 279 is applied to disallow interest.

Application to Passthrough Entities

In General

In the case of any partnership, the limitation is applied at the partnership level. Any deduction for business interest is taken into account in determining all taxable items of income, gain, deduction, or loss of the partnership.[635] To prevent double counting, special rules are provided for the determination of the adjusted taxable income of each partner of the partnership. Similarly, to allow for additional interest deduction by a partner in the case of an excess amount of unused adjusted taxable income limitation of the partnership, special rules apply. Similar rules apply with respect to any S corporation and its shareholders.

Double Counting Rule

The adjusted taxable income of each partner (or shareholder, as the case may be) is determined without regard to such partner's distributive share of all items of income, gain, deduction, or loss of such partnership. In the absence of such a rule, the same dollars of adjusted taxable income of a partnership could generate additional interest deductions as the income is passed through to the partners.

Additional Deduction Limit

The limit on the amount allowed as a deduction for business interest is increased by a partner's distributive share of the partnership's excess taxable income. The excess taxable income with respect to any partnership is the amount which bears the same ratio to the partnership's adjusted taxable income as the excess (if any) of 30 percent of the adjusted taxable income of the partnership over the amount (if any) by which the business interest of the partnership, reduced by floor plan financing interest, exceeds the business interest income of the partnership bears to 30 percent of the adjusted taxable income of the partnership. This allows a partner of a partnership to deduct additional interest expense the partner may have paid or incurred to the extent the partnership could have deducted more business interest. The provision requires that excess taxable income be allocated in the same manner as nonseparately stated income and loss. Similar rules also apply to S corporations.

[635] This amount is the ''Ordinary business income or loss" reflected on Form 1065 (U.S. Return of Partnership Income). The partner's distributive share is reflected in Box 1 of Schedule K-1 (Form 1065).

The provision provides a special rule for carryforward of disallowed partnership interest. In the case of a partnership, the general carryforward rule described below does not apply. Instead, any business interest that is not allowed as a deduction to the partnership for the taxable year is allocated to each partner in the same manner as nonseparately stated taxable income or loss of the partnership. The partner may deduct its share of the partnership's excess business interest in any future year, but only against excess taxable income attributed to the partner by the partnership the activities of which gave rise to the excess business interest carryforward. Any such deduction requires a corresponding reduction in excess taxable income. Additionally, when excess business interest is allocated to a partner, the partner's basis in its partnership interest is reduced (but not below zero) by the amount of such allocation, even though the carryforward does not give rise to a partner deduction in the year of the basis reduction. However, the partner's deduction in a future year for interest carried forward does not reduce the partner's basis in the partnership interest. In the event the partner disposes of a partnership interest the basis of which has been so reduced, the partner's basis in such interest shall be increased, immediately before such disposition, by the amount that any such basis reductions exceed any amount of excess interest expense that has been treated as paid by the partner (*i.e.*, excess interest expense that has been deducted by the partner against excess taxable income of the same partnership). This special rule does not apply to S corporations and their shareholders.

Carryforward of Disallowed Business Interest

The amount of any business interest not allowed as a deduction for any taxable year is treated as business interest paid or accrued in the succeeding taxable year. Business interest may be carried forward indefinitely, subject to certain restrictions applicable to partnerships, described above.

A coordination rule is provided with the limitation on deduction of interest by domestic corporations in international financial reporting groups.[636] Whichever rule imposes the lower limitation on deduction of business interest with respect to the taxable year (and therefore the greatest amount of interest to be carried forward) governs.

Any carryforward of disallowed business interest is an item taken into account in the case of certain corporate acquisitions described in IRC section 381 and is subject to limitation under IRC section 382.

Exceptions

The limitation does not apply to any taxpayer that meets the $15 million gross receipts test of IRC section 448(c), that is, if the average annual gross receipts for the three-taxable-year period ending with the prior taxable year does not exceed $15 million.[637] Aggregation rules apply to determine the amount of a taxpayer's gross receipts under the gross receipts test of IRC section 448(c).

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[636] See section 4302 of the bill (Limitation on deduction of interest by domestic corporations which are members of an international financial reporting group).

[637] See section 13102 of the provision (Modifications of gross receipts test for use of cash method of accounting by corporations and partnerships). In the case of a sole proprietorship, the $15 million gross receipts test is applied as if the sole proprietorship were a corporation or partnership.

The trade or business of performing services as an employee is not treated as a trade or business for purposes of the limitation. As a result, for example, the wages of an employee are not counted in the adjusted taxable income of the taxpayer for purposes of determining the limitation.

At the taxpayer's election, any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business is not treated as a trade or business for purposes of the limitation, and therefore the limitation does not apply to such trades or businesses.[638] Similarly, at the taxpayer's election, any farming business,[639] as well as any business engaged in the trade or business of a specified agricultural or horticultural cooperative,[640] are not treated as trades or businesses for purposes of the limitation, and therefore the limitation does not apply to such trades or businesses.

The limitation does not apply to certain regulated public utilities. Specifically, the trade or business of the furnishing or sale of (1) electrical energy, water, or sewage disposal services, (2) gas or steam through a local distribution system, or (3) transportation of gas or steam by pipeline, if the rates for such furnishing or sale, as the case may be, have been established or approved by a State[641] or political subdivision thereof, by any agency or instrumentality of the United States, by a public service or public utility commission or other similar body of any State or political subdivision thereof, or the governing or ratemaking body of an electric cooperative is not treated as a trade or business for purposes of the limitation. As a result, for example, interest expense paid or incurred in a real property trade or business is not business interest subject to limitation and is generally deductible in the computation of taxable income.

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638 It is intended that any such real property trade or business, including such a trade or business conducted by a corporation or real estate investment trust, be included. Because this description of a real property trade or business refers only to the IRC section 469(c)(7)(C) description, and not to other rules of IRC section 469 (such as the rule of IRC section 469(c)(2) that passive activities include rental activities or the rule of IRC section 469(a) that a passive activity loss is limited under IRC section 469), the other rules of IRC section 469 are not made applicable by this reference. It is further intended that a real property operation or a real property management trade or business includes the operation or management of a lodging facility.

639 As defined in IRC section 263A(e)(4) (*i.e.*, farming business means the trade or business of farming and includes the trade or business of operating a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees (other than evergreen trees that are more than six years old at the time they are severed from their roots)). Treasury Regulation section 1.263A-4(a)(4) further defines a farming business as a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity. Examples of a farming business include the trade or business of operating a nursery or sod farm; the raising or harvesting of trees bearing fruit, nuts, or other crops; the raising of ornamental trees (other than evergreen trees that are more than six years old at the time they are severed from their roots); and the raising, shearing, feeding, caring for, training, and management of animals. A farming business also includes processing activities that are normally incident to the growing, raising, or harvesting of agricultural or horticultural products. See Treasury Regulation section 1.263A-4(a)(4)(i) and (ii). A farming business does not include contract harvesting of an agricultural or horticultural commodity grown or raised by another taxpayer, or merely buying and reselling plants or animals grown or raised by another taxpayer. See Treasury Regulation section 1.263A-4(a)(4)(i).

640 As defined in new IRC section 199A(g)(2) under the Senate amendment. See section 11011 of the Senate amendment (Deduction for qualified business income).

641 The term "State" includes the District of Columbia. See IRC section 7701(a)(10) ("The term 'State' shall be construed to include the District of Columbia where such construction is necessary to carry out provisions of this title").

Effective Dates

The provision applies to taxable years beginning after December 31, 2017.

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

California conforms, under the PITL and the CTL, to the federal rules for the deduction of interest under IRC section 163, as of the "specified date" of January 1, 2015,[642] with modifications, but does not conform to the federal limitations on deductions of business interest.

Impact on California Revenue

Estimated Conformity Revenue Impact of Limitation on Deduction for Interest For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	$650,000,000	$650,000,000	$650,000,000

Section	Section Title
13302	Modification of Net Operating Loss Deduction

Background

A net operating loss ("NOL") generally means the amount by which a taxpayer's business deductions exceed its gross income.[643] In general, an NOL may be carried back two years and carried over 20 years to offset taxable income in such years.[644] NOLs offset taxable income in the order of the taxable years to which the NOL may be carried.[645]

Different carryback periods apply with respect to NOLs arising in different circumstances. Extended carryback periods are allowed for NOLs attributable to specified liability losses and certain casualty and disaster losses.[646] Limitations are placed on the carryback of excess interest losses attributable to corporate equity reduction transactions.[647]

[642] R&TC sections 17024.5 and 23051.5.
[643] IRC section 172(c).
[644] IRC section 172(b)(1)(A).
[645] IRC section 172(b)(2).
[646] IRC section 172(b)(1)(C) and (E).
[647] IRC section 172(b)(1)(D).

New Federal Law

The provision limits the NOL deduction to 80 percent of taxable income (determined without regard to the deduction). Carryovers to other years are adjusted to take account of this limitation, and may be carried forward indefinitely. The limitation does not apply to a property and casualty insurance company.

The provision repeals the two-year carryback and the special carryback provisions, but provides a two-year carryback in the case of certain disaster losses incurred in the trade or business of farming.

In addition, the provision provides a two-year carryback and 20-year carryforward for NOLs of a property and casualty insurance company (defined in IRC section 816(a)) as an insurance company other than a life insurance company).

Effective Dates

The provision limiting the NOL deduction applies to losses arising in taxable years beginning after December 31, 2017. The provision allowing indefinite carryovers and modifying carrybacks generally applies to losses arising in taxable years ending after December 31, 2017.

California Law (R&TC sections 17201, 17207, 17276-17276.22, and 24416 - 24416.22)

California conforms, under the PITL and the CTL, to the federal rules for the calculation of an NOL and the allowance of an NOL deduction under IRC section 172, as of the "specified date" of January 1, 2015,[648] with modifications, but does not conform to the changes to the NOL provisions.

Impact on California Revenue

Estimated Conformity Revenue Impact of Modification of Net Operating Loss Deduction For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
$600,000,000	$750,000,000	$650,000,000	$650,000,000

[648] R&TC section 17024.5 and 23051.5.

Section	Section Title
13303	Like-Kind Exchanges of Real Property

Background

An exchange of property, like a sale, generally is a taxable event. However, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like kind" which is to be held for productive use in a trade or business or for investment.[649] In general, IRC section 1031 does not apply to any exchange of stock in trade (*i.e.*, inventory) or other property held primarily for sale; stocks, bonds, or notes; other securities or evidences of indebtedness or interest; interests in a partnership; certificates of trust or beneficial interests; or choses in action.[650] IRC section 1031 also does not apply to certain exchanges involving livestock[651] or foreign property.[652]

For purposes of IRC section 1031, the determination of whether property is of a "like kind" relates to the nature or character of the property and not its grade or quality, *i.e.*, the nonrecognition rules do not apply to an exchange of one class or kind of property for property of a different class or kind (*e.g.*, IRC section 1031 does not apply to an exchange of real property for personal property).[653] The different classes of property are: (1) depreciable tangible personal property;[654] (2) intangible or nondepreciable personal property;[655] and (3) real property.[656] However, the rules with respect to whether real estate is "like kind" are applied more liberally than the rules governing like-kind exchanges of depreciable, intangible, or nondepreciable personal property. For example, improved real estate and unimproved real estate generally are considered to be property of a "like kind" as this distinction relates to the grade or quality of the real estate,[657]

[649] IRC section 1031(a)(1).
[650] IRC section 1031(a)(2). A chose in action is a right that can be enforced by legal action.
[651] IRC section 1031(e).
[652] IRC section 1031(h).
[653] Treasury Regulation section 1.1031(a)-1(b).
[654] For example, an exchange of a personal computer classified under asset class 00.12 of Revenue Procedure 87-56, 1987-2 C.B. 674, for a printer classified under the same asset class of Revenue Procedure 87-56 would be treated as property of a like kind. However, an exchange of an airplane classified under asset class 00.21 of Revenue Procedure 87-56 for a heavy general purpose truck classified under asset class 00.242 of Revenue Procedure 87-56 would not be treated as property of a like kind. See Treasury Regulation section 1.1031(a)-2(b)(7).
[655] For example, an exchange of a copyright on a novel for a copyright on a different novel would be treated as property of a like kind. See Treasury Regulation section 1.1031(a)-2(c)(3). However, the goodwill or going concern value of one business is not of a like kind to the goodwill or going concern value of a different business. See Treasury Regulation section 1.1031(a)-2(c)(2). The IRS has ruled that intangible assets such as trademarks, trade names, mastheads, and customer-based intangibles that can be separately described and valued apart from goodwill qualify as property of a like kind under section 1031. See Chief Counsel Advice 200911006, February 12, 2009.
[656] Treasury Regulation section 1.1031(a)-1(b) and (c).
[657] Treasury Regulation section 1.1031(a)-1(b).

while depreciable tangible personal properties must be either within the same General Asset Class[658] or within the same Product Class.[659]

The nonrecognition of gain in a like-kind exchange applies only to the extent that like-kind property is received in the exchange. Thus, if an exchange of property would meet the requirements of IRC section 1031, but for the fact that the property received in the transaction consists not only of the property that would be permitted to be exchanged on a tax-free basis, but also other nonqualifying property or money ("additional consideration"), then the gain to the recipient of the other property or money is required to be recognized, but not in an amount exceeding the fair market value of such other property or money.[660] Additionally, any such gain realized on an IRC section 1031 exchange as a result of additional consideration being involved constitutes ordinary income to the extent that the gain is subject to the recapture provisions of IRC sections 1245 and 1250.[661] No losses may be recognized from a like-kind exchange.[662]

If IRC section 1031 applies to an exchange of properties, the basis of the property received in the exchange is equal to the basis of the property transferred. This basis is increased to the extent of any gain recognized as a result of the receipt of other property or money in the like-kind exchange, and decreased to the extent of any money received by the taxpayer.[663] The holding period of qualifying property received includes the holding period of the qualifying property transferred, but the nonqualifying property received is required to begin a new holding period.[664]

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[658] Treasury Regulation section 1.1031(a)-2(b)(2) provides the following list of General Asset Classes, based on asset classes 00.11 through 00.28 and 00.4 of Revenue Procedure 87-56, 1987-2 C.B. 674: (i) Office furniture, fixtures, and equipment (asset class 00.11), (ii) Information systems (computers and peripheral equipment) (asset class 00.12), (iii) Data handling equipment, except computers (asset class 00.13), (iv) Airplanes (airframes and engines), except those used in commercial or contract carrying of passengers or freight, and all helicopters (airframes and engines) (asset class 00.21), (v) Automobiles, taxis (asset class 00.22), (vi) Buses (asset class 00.23), (vii) Light general purpose trucks (asset class 00.241), (viii) Heavy general purpose trucks (asset class 00.242), (ix) Railroad cars and locomotives, except those owned by railroad transportation companies (asset class 00.25), (x) Tractor units for use over-the-road (asset class 00.26), (xi) Trailers and trailer-mounted containers (asset class 00.27), (xii) Vessels, barges, tugs, and similar water-transportation equipment, except those used in marine construction (asset class 00.28), and (xiii) Industrial steam and electric generation and/or distribution systems (asset class 00.4).

[659] Property within a product class consists of depreciable tangible personal property that is described in a 6-digit product class within Sectors 31, 32, and 33 (pertaining to manufacturing industries) of the North American Industry Classification System ("NAICS"), set forth in Executive Office of the President, Office of Management and Budget, *North American Industry Classification System*, United States, 2002 (NAICS Manual), as periodically updated. Treasury Regulation section 1.1031(a)-2(b)(3).

[660] IRC section 1031(b). For example, if a taxpayer holding land A having a basis of $40,000 and a fair market value of $100,000 exchanges the property for land B worth $90,000 plus $10,000 in cash, the taxpayer would recognize $10,000 of gain on the transaction, which would be includable in income. The remaining $50,000 of gain would be deferred until the taxpayer disposes of land B in a taxable sale or exchange.

[661] IRC sections 1245(b)(4) and 1250(d)(4). For example, if a taxpayer holding section 1245 property A with an original cost basis of $11,000, an adjusted basis of $10,000, and a fair market value of $15,000 exchanges the property for section 1245 property B with a fair market value of $14,000 plus $1,000 in cash, the taxpayer would recognize $1,000 of ordinary income on the transaction. The remaining $4,000 of gain would be deferred until the taxpayer disposes of section 1245 property B in a taxable sale or exchange.

[662] IRC section 1031(c).

[663] IRC section 1031(d). Thus, in the example noted above, the taxpayer's basis in B would be $40,000 (the taxpayer's transferred basis of $40,000, increased by $10,000 in gain recognized, and decreased by $10,000 in money received).

[664] IRC section 1223(1).

A like-kind exchange also does not require that the properties be exchanged simultaneously. Rather, the property to be received in the exchange must be received not more than 180 days after the date on which the taxpayer relinquishes the original property (but in no event later than the due date (including extensions) of the taxpayer's income tax return for the taxable year in which the transfer of the relinquished property occurs). In addition, the taxpayer must identify the property to be received within 45 days after the date on which the taxpayer transfers the property relinquished in the exchange.[665]

The Treasury Department has issued regulations[666] and revenue procedures[667] providing guidance and safe harbors for taxpayers engaging in deferred like-kind exchanges.

New Federal Law (IRC section 1031)

The provision modifies the existing law providing for nonrecognition of gain in the case of like-kind exchanges by limiting its application to real property that is not held primarily for sale.[668] In addition, the new special rule applies to foreign real property such that real property within the United States and real property outside of the United States are not property of a like kind.

Effective Dates

The provision generally applies to exchanges completed after December 31, 2017. However, an exception is provided for any exchange if the property disposed of by the taxpayer in the exchange is disposed of on or before December 31, 2017, or the property received by the taxpayer in the exchange is received on or before such date.

California Law (R&TC sections 18031, 18031.5, 18032, 24941, and 24953)

California conforms, under the PITL and the CTL, to the federal rules for the exchange for property held for productive use or investment (like-kind exchanges) under IRC section 1031, as of the "specified date" of January 1, 2015,[669] with modifications, but does not conform to the federal limiting like-kind exchanges to real property that is not held primarily for sale.

[665] IRC section 1031(a)(3).
[666] Treasury Regulation section 1.1031(k)-1(a) through (o).
[667] See Revenue Procedure 2000-37, 2000-40 I.R.B. 308, as modified by Revenue Procedure 2004-51, 2004-33 I.R.B. 294.
[668] It is intended that real property eligible for like-kind exchange treatment under present law will continue to be eligible for like-kind exchange treatment under the provision. For example, a like-kind exchange of real property includes an exchange of shares in a mutual ditch, reservoir, or irrigation company described in IRC section 501(c)(12)(A) if at the time of the exchange such shares have been recognized by the highest court or statute of the State in which the company is organized as constituting or representing real property or an interest in real property. Similarly, improved real estate and unimproved real estate are generally considered to be property of a like kind. See Treasury Regulation section 1.1031(a)-1(b).
[669] R&TC sections 17024.5 and 23051.5.

In addition, California has an annual information reporting requirement for taxpayers that claim nonrecognition of gain or loss for a like-kind exchange when property in California is exchanged for property located outside of California. For such an exchange, taxpayers are required to file an information return in the taxable year of the exchange and in each subsequent taxable year in which the gain or loss attributable to the exchange has not been recognized.

Failure to comply with that reporting requirement and fail to file a return to properly report the recognition of the gain or loss attributable to the exchange, may result in the FTB making an estimate of the net income from the exchange using any available information, including the amount of deferred gain or loss reported in the year of the exchange, and proposing to assess the amount of tax, interest, and penalties due in the same manner as assessments that are proposed for the failure to file a return.

Impact on California Revenue

Estimated Conformity Revenue Impact of Like-Kind Exchanges of Real Property For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	$130,000,000	$130,000,000	$170,000,000

Section	Section Title
13304	Limitation on Deduction by Employers of Expenses for Fringe Benefits

Background

In General

No deduction is allowed with respect to (1) an activity generally considered to be entertainment, amusement, or recreation ("entertainment"), unless the taxpayer establishes that the item was directly related to (or, in certain cases, associated with) the active conduct of the taxpayer's trade or business, or (2) a facility (*e.g.*, an airplane) used in connection with such activity.[670] If the taxpayer establishes that entertainment expenses are directly related to (or associated with) the active conduct of its trade or business, the deduction generally is limited to 50 percent of the amount otherwise deductible.[671] Similarly, a deduction for any expense for food or beverages generally is limited to 50 percent of the amount otherwise deductible.[672] In addition, no

[670] IRC section 274(a)(1).
[671] IRC section 274(n)(1)(B).
[672] IRC section 274(n)(1)(A).

deduction is allowed for membership dues with respect to any club organized for business, pleasure, recreation, or other social purpose.[673]

There are a number of exceptions to the general rule disallowing deduction of entertainment expenses and the rules limiting deductions to 50 percent of the otherwise deductible amount. Under one such exception, those rules do not apply to expenses for goods, services, and facilities to the extent that the expenses are reported by the taxpayer as compensation and as wages to an employee.[674] Those rules also do not apply to expenses for goods, services, and facilities to the extent that the expenses are includible in the gross income of a recipient who is not an employee (*e.g.,* a nonemployee director) as compensation for services rendered or as a prize or award.[675] The exceptions apply only to the extent that amounts are properly reported by the company as compensation and wages or otherwise includible in income. In no event can the amount of the deduction exceed the amount of the taxpayer's actual cost, even if a greater amount (i.e., fair market value) is includible in income.[676]

Those deduction disallowance rules also do not apply to expenses paid or incurred by the taxpayer, in connection with the performance of services for another person (other than an employer), under a reimbursement or other expense allowance arrangement if the taxpayer accounts for the expenses to such person.[677] Another exception applies for expenses for recreational, social, or similar activities primarily for the benefit of employees other than certain owners and highly compensated employees.[678] An exception applies also to the 50 percent deduction limit for food and beverages provided to crew members of certain commercial vessels and certain oil or gas platform or drilling rig workers.[679]

Expenses Treated as Compensation

Except as otherwise provided, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items.[680] In general, an employee (or other service provider) must include in gross income the amount by which the fair market value of a fringe benefit exceeds the sum of the amount (if any) paid by the individual and the amount (if any) specifically excluded from gross income.[681] Treasury regulations provide detailed rules regarding the valuation of certain fringe benefits, including flights on an employer-provided aircraft. In general, the value of a noncommercial flight generally is determined under the base aircraft valuation formula, also known as the Standard Industry Fare Level formula (SIFL).[682] If the SIFL valuation rules do not apply, the value of a flight on an employer-provided aircraft generally is equal to the amount that an individual would have to pay in an arm's-length transaction to charter the same or a comparable aircraft for that period for the same or a comparable flight.[683]

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[673] IRC section 274(a)(3).
[674] IRC section 274(e)(2)(A). See below for a discussion of the recent modification of this rule for certain individuals.
[675] IRC section 274(e)(9).
[676] Treasury Regulation section 1.162-25T(a).
[677] IRC section 274(e)(3).
[678] IRC section 274(e)(4).
[679] IRC section 274(n)(2)(E).
[680] IRC section 61(a)(1).
[681] Treasury Regulation section 1.61-21(b)(1).
[682] Treasury Regulation section 1.61-21(g)(5).
[683] Treasury Regulation section 1.61-21(b)(6).

In the context of an employer providing an aircraft to employees for nonbusiness (*e.g.,* vacation) flights, the exception for expenses treated as compensation has been interpreted as not limiting the company's deduction for expenses attributable to the operation of the aircraft to the amount of compensation reportable to its employees.[684] The result of that interpretation is often a deduction several times larger than the amount required to be included in income. Further, in many cases, the individual including amounts attributable to personal travel in income directly benefits from the enhanced deduction, resulting in a net deduction for the personal use of the company aircraft.

The exceptions for expenses treated as compensation or otherwise includible income were subsequently modified in the case of specified individuals such that the exceptions apply only to the extent of the amount of expenses treated as compensation or includible in income of the specified individual.[685] Specified individuals are individuals who, with respect to an employer or other service recipient (or a related party), are subject to the requirements of section 16(a) of the Securities Exchange Act of 1934, or would be subject to such requirements if the employer or service recipient (or related party) were an issuer of equity securities referred to in section 16(a).[686]

As a result, in the case of specified individuals, no deduction is allowed with respect to expenses for (1) a nonbusiness activity generally considered to be entertainment, amusement or recreation, or (2) a facility (*e.g.,* an airplane) used in connection with such activity to the extent that such expenses exceed the amount treated as compensation or includible in income to the specified individual. For example, a company's deduction attributable to aircraft operating costs and other expenses for a specified individual's vacation use of a company aircraft is limited to the amount reported as compensation to the specified individual. However, in the case of other employees or service providers, the company's deduction is not limited to the amount treated as compensation or includible in income.[687]

Excludable Fringe Benefits

Certain employer-provided fringe benefits are excluded from an employee's gross income and wages for employment tax purposes, including, but not limited to, *de minimis* fringes, qualified transportation fringes, on-premises athletic facilities, and meals provided for the "convenience of the employer."[688]

A *de minimis* fringe generally means any property or service the value of which is (taking into account the frequency with which similar fringes are provided by the employer) so small as to make accounting for it unreasonable or administratively impracticable,[689] and also includes food

[684] *Sutherland Lumber-Southwest, Inc. v. Commissioner*, 114 T.C. 197 (2000), aff'd, 255 F.3d 495 (8th Cir. 2001).
[685] IRC section 274(e)(2)(B)(i). See also Treasury Regulation section 1.274-9(a).
[686] IRC section 274(e)(2)(B)(ii). See also Treasury Regulation section 1.274-9(b).
[687] See Treasury Regulation section 1.274-10(a)(2).
[688] IRC sections 132(a), 119(a), 3121(a)(19) and (20), 3231(e)(5) and (9), 3306(b)(14) and (16), and 3401(a)(19).
[689] IRC section 132(e)(1). Examples include occasional personal use of an employer's copying machine, occasional parties or meals for employees and their guests, local telephone calls, and coffee, doughnuts and soft drinks. Treasury Regulation section 1.132-6(e)(1).

and beverages provided to employees through an eating facility operated by the employer that is located on or near the employer's business premises and meets certain requirements.[690] Qualified transportation fringes include qualified parking (parking on or near the employer's business premises or on or near a location from which the employee commutes to work by public transit), transit passes, vanpool benefits, and qualified bicycle commuting reimbursements.[691]

On-premises athletic facilities are gyms or other athletic facilities located on the employer's premises, operated by the employer, and substantially all the use of which is by employees of the employer, their spouses, and their dependent children.[692]

The value of meals furnished to an employee or the employee's spouse or dependents by or on behalf of an employer for the convenience of the employer is excludible from the employee's gross income, but only if such meals are provided on the employer's business premises.[693]

<u>New Federal Law (IRC section 274)</u>

The provision provides that no deduction is allowed with respect to (1) an activity generally considered to be entertainment, amusement or recreation, (2) membership dues with respect to any club organized for business, pleasure, recreation or other social purposes, or (3) a facility or portion thereof used in connection with any of the above items. Thus, the provision repeals the present-law exception to the deduction disallowance for entertainment, amusement, or recreation that is directly related to (or, in certain cases, associated with) the active conduct of the taxpayer's trade or business (and the related rule applying a 50 percent limit to such deductions).

In addition, the provision disallows a deduction for expenses associated with providing any qualified transportation fringe to employees of the taxpayer, and except as necessary for ensuring the safety of an employee, any expense incurred for providing transportation (or any payment or reimbursement) for commuting between the employee's residence and place of employment.

Taxpayers may still generally deduct 50 percent of the food and beverage expenses associated with operating their trade or business (*e.g.,* meals consumed by employees on work travel). For amounts incurred and paid after December 31, 2017, and before January 1, 2026, the provision expands this 50 percent limitation to expenses of the employer associated with providing food and beverages to employees through an eating facility that meets requirements for *de minimis* fringes and for the convenience of the employer. Such amounts incurred and paid after December 31, 2025, are not deductible.

<u>Effective Dates</u>

The provision generally applies to amounts paid or incurred after December 31, 2017. However, for expenses of the employer associated with providing food and beverages to employees through

[690] IRC section 132(e)(2). Revenue derived from such a facility must normally equal or exceed the direct operating costs of the facility. Employees who are entitled, under Section 119, to exclude the value of a meal provided at such a facility are treated as having paid an amount for the meal equal to the direct operating costs of the facility attributable to such meal.
[691] IRC section 132(f)(1), (5). The qualified transportation fringe exclusions are subject to monthly limits. IRC section 132(f)(2).
[692] IRC section 132(j)(4).
[693] IRC section 119(a).

an eating facility that meets requirements for *de minimis* fringes and for the convenience of the employer, amounts paid or incurred after December 31, 2025 are not deductible.

California Law (R&TC sections 17201 and 24443)

California conforms, under the PITL and the CTL, to the federal rules for the deductibility of fringe benefits under IRC section 274, as of the "specified date" of January 1, 2015,[694] but does not conform to the repeal of the present-law exception under federal law relating to the deduction disallowance for entertainment, amusement, or recreation that is directly related to the active conduct of a trade or business.

Impact on California Revenue

Estimated Conformity Revenue Impact of Limitation on Deduction by Employers of Expenses for Fringe Benefits[695] For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	$200,000,000	$150,000,000	$150,000,000

Section	Section Title
13305	Repeal of Deduction for Income Attributable to Domestic Production Activities

Background

In General

IRC section 199 provides a deduction from taxable income (or, in the case of an individual, AGI[696]) that is equal to nine percent of the lesser of the taxpayer's qualified production activities income or taxable income (determined without regard to the IRC section 199 deduction) for the taxable year.[697] For corporations subject to the 35-percent corporate income tax rate, the nine-percent deduction effectively reduces the corporate income tax rate to slightly less than 32 percent on

[694] R&TC sections 17024.5 and 23051.5.
[695] Amounts include revenue estimates for Act sections 13304 and 13703 combined.
[696] For this purpose, AGI is determined after application of sections 86, 135, 137, 219, 221, 222, and 469, without regard to the section 199 deduction. IRC section 199(d)(2).
[697] IRC section 199(a). In the case of oil related qualified production activities income, the deduction from taxable income is equal to six percent of the lesser of the taxpayer's oil related qualified production activities income, qualified production activities income, or taxable income. IRC section 199(d)(9).

qualified production activities income.[698] A similar reduction applies to the graduated rates applicable to individuals with qualifying domestic production activities income.

In general, qualified production activities income is equal to domestic production gross receipts reduced by the sum of: (1) the costs of goods sold that are allocable to those receipts; and (2) other expenses, losses, or deductions which are properly allocable to those receipts.[699]

Domestic production gross receipts generally are gross receipts of a taxpayer that are derived from: (1) any sale, exchange, or other disposition, or any lease, rental, or license, of qualifying production property[700] that was manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the United States;[701] (2) any sale, exchange, or other disposition, or any lease, rental, or license, of qualified film[702] produced by the taxpayer; (3) any sale, exchange, or other disposition, or any lease, rental, or license, of electricity, natural gas, or potable water produced by the taxpayer in the United States; (4) construction of real property performed in the United States by a taxpayer in the ordinary course of a construction trade or business; or (5) engineering or architectural services performed in the United States for the construction of real property located in the United States.[703]

The amount of the deduction for a taxable year is limited to 50 percent of the W-2 wages paid by the taxpayer, and properly allocable to domestic production gross receipts, during the calendar year that ends in such taxable year.[704]

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[698] This example assumes the deduction does not exceed the wage limitation discussed below.
[699] IRC section 199(c)(1). In computing qualified production activities income, the domestic production activities deduction itself is not an allocable deduction. IRC section 199(c)(1)(B)(ii). See Treasury Regulation sections 1.199-1 through 1.199-9 where the Secretary has prescribed rules for the proper allocation of items of income, deduction, expense, and loss for purposes of determining qualified production activities income.
[700] Qualifying production property generally includes any tangible personal property, computer software, and sound recordings. IRC section 199(c)(5).
[701] When used in the Code in a geographical sense, the term ''United States" generally includes only the States and the District of Columbia. IRC section 7701(a)(9). A special rule for determining domestic production gross receipts, however, provides that for taxable years beginning after December 31, 2005, and before January 1, 2017, in the case of any taxpayer with gross receipts from sources within the Commonwealth of Puerto Rico, the term ''United States" includes the Commonwealth of Puerto Rico, but only if all of the taxpayer's Puerto Rico-sourced gross receipts are taxable under the Federal income tax for individuals or corporations for such taxable year. IRC sections 199(d)(8)(A) and (C). In computing the 50-percent wage limitation, the taxpayer is permitted to take into account wages paid to bona fide residents of Puerto Rico for services performed in Puerto Rico. IRC section 199(d)(8)(B).
[702] Qualified film includes any motion picture film or videotape (including live or delayed television programming, but not including certain sexually explicit productions) if 50 percent or more of the total compensation relating to the production of the film (including compensation in the form of residuals and participations) constitutes compensation for services performed in the United States by actors, production personnel, directors, and producers. IRC section 199(c)(6).
[703] IRC section 199(c)(4)(A).
[704] IRC section 199(b)(1). For purposes of the provision, "W-2 wages" include the sum of the amounts of wages as defined in IRC section 3401(a) and elective deferrals that the taxpayer properly reports to the Social Security Administration with respect to the employment of employees of the taxpayer during the calendar year ending during the taxpayer's taxable year. Elective deferrals include elective deferrals as defined in IRC section 402(g)(3), amounts deferred under IRC section 457, and designated Roth contributions as defined in IRC section 402A. See IRC section 199(b)(2)(A). The wage limitation for qualified films includes any compensation for services performed in the United States by actors, production personnel, directors, and producers and is not restricted to W-2 wages. IRC section 199(b)(2)(D).

Agricultural and Horticultural Cooperatives

With regard to member-owned agricultural and horticultural cooperatives formed under Subchapter T of the Code, IRC section 199 provides the same treatment of qualified production activities income derived from agricultural or horticultural products that are manufactured, produced, grown, or extracted by cooperatives,[705] or that are marketed through cooperatives, as it provides for qualified production activities income of other taxpayers (*i.e.*, the cooperative may claim a deduction from qualified production activities income).

In addition, IRC section 199(d)(3)(A) provides that the amount of any patronage dividends or per-unit retain allocations paid to a member of an agricultural or horticultural cooperative (to which Part I of Subchapter T applies), which is allocable to the portion of qualified production activities income of the cooperative that is deductible under the provision, is deductible from the gross income of the member. In order to qualify, such amount must be designated by the organization as allocable to the deductible portion of qualified production activities income in a written notice mailed to its patrons not later than the payment period described in IRC section 1382(d). In addition, IRC section 199(d)(3)(B) provides that the cooperative cannot reduce its income under IRC section 1382 (e.g., cannot claim a dividends-paid deduction) for such amounts.

<u>New Federal Law (IRC section 199)</u>

The provision repeals the deduction for income attributable to domestic production activities.

<u>Effective Dates</u>

The provision is effective for C corporations, and for certain rules applicable to agricultural and horticultural cooperatives provided in IRC section 199(d)(3)(A) and (B) for taxable years beginning after December 31, 2017.

<u>California Law (R&TC sections 17201 and 17201.6)</u>

California does not conform, under the PITL and the CTL, to IRC section 199 relating to the federal rules for income attributable to domestic production activities. Thus, the federal repeal of IRC section 199 is not applicable for California purposes.

[705] For this purpose, agricultural or horticultural products also include fertilizer, diesel fuel and other supplies used in agricultural or horticultural production that are manufactured, produced, grown, or extracted by the cooperative.

Impact on California Revenue

Estimated Conformity Revenue Impact of Repeal of Deduction for Income Attributable to Domestic Production Activities For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	N/A	N/A	N/A

Section Section Title

13306 Denial of Deduction for Certain Fines, Penalties, and Other Amounts

Background

The Code denies a deduction for fines or penalties paid to a government for the violation of any law.[706]

New Federal Law (IRC sections 162 and 6050X)

The provision denies deductibility for any otherwise deductible amount paid or incurred (whether by suit, agreement, or otherwise) to or at the direction of a government or specified nongovernmental entity in relation to the violation of any law or the investigation or inquiry by such government or entity into the potential violation of any law. An exception applies to payments that the taxpayer establishes are either restitution (including remediation of property) or amounts required to come into compliance with any law that was violated or involved in the investigation or inquiry, that are identified in the court order or settlement agreement as restitution, remediation, or required to come into compliance. In the case of any amount of restitution for failure to pay any tax and assessed as restitution under the Code, such restitution is deductible only to the extent it would have been allowed as a deduction if it had been timely paid. The IRS remains free to challenge the characterization of an amount so identified; however, no deduction is allowed unless the identification is made. Restitution or included remediation of property does not include reimbursement of government investigative or litigation costs.

The provision applies only where a government (or other entity treated in a manner similar to a government under the provision) is a complainant or investigator with respect to the violation or potential violation of any law.[707] An exception also applies to any amount paid or incurred as taxes due.

[706] IRC section 162(f).
[707] Thus, for example, the provision does not apply to payments made by one private party to another in a lawsuit between private parties, merely because a judge or jury acting in the capacity as a court directs the payment to be

The provision requires government agencies (or entities treated as such agencies under the provision) to report to the IRS and to the taxpayer the amount of each settlement agreement or order entered into where the aggregate amount required to be paid or incurred to or at the direction of the government is at least $600 (or such other amount as may be specified by the Secretary of the Treasury as necessary to ensure the efficient administration of the Internal Revenue laws). The report must separately identify any amounts that are for restitution or remediation of property, or correction of noncompliance. The report must be made at the time the agreement is entered into, as determined by the Secretary of the Treasury.

Effective Dates

The provision denying the deduction and the reporting provision are effective for amounts paid or incurred on or after the date of enactment of the Act (December 22, 2017), except that it would not apply to amounts paid or incurred under any binding order or agreement entered into before such date. Such exception does not apply to an order or agreement requiring court approval unless the approval was obtained before such date.

California Law (R&TC sections 17201, 17274, 17282, 17286, 18631, and 24436.1.)

California conforms, under the PITL and the CTL, to the federal rules for trade or business expense deductions under IRC section 162, with modifications, as of the "specified date" of January 1, 2015.[708] California law provides a denial of deductions in computing taxable income or net income from any act or omission of criminal profiteering activity (as defined) and deductions from gross income for income derived from any other activities which directly tend to promote or further or are directly connected to or associated with those act or omissions. California does not conform to the present federal specific denial of a deduction for certain fines, penalties, and other amounts.

California law provides, under the Administration of Franchise and Income Tax Law (AFITL), that the FTB may require a copy of any information return required to be filed with the Secretary of the Treasury under IRC section 6050X, relating to suits or agreements with respect to violation of any applicable law, at the time and in the form and manner as the FTB may, by forms and instructions, require.

made. The mere fact that a court enters a judgment or directs a result in a private dispute does not cause the payment to be made ''at the direction of a government'' for purposes of the provision.

[708] R&TC sections 17024.5 and 23051.5.

Impact on California Revenue

Estimated Conformity Revenue Impact of Denial of Deduction for Certain Fines, Penalties, and Other Amounts For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	$600,000	$400,000	$350,000

Section	Section Title
13307	Denial of Deduction for Settlements Subject to Nondisclosure Agreements Paid in Connection with Sexual Harassment or Sexual Abuse

Background

A taxpayer generally is allowed a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business.[709] However, certain exceptions apply. No deduction is allowed for (1) any charitable contribution or gift that would be allowable as a deduction under IRC section 170 were it not for the percentage limitations, the dollar limitations, or the requirements as to the time of payment, set forth in such section; (2) any illegal bribe, illegal kickback, or other illegal payment; (3) certain lobbying and political expenditures; (4) any fine or similar penalty paid to a government for the violation of any law; (5) two-thirds of treble damage payments under the antitrust laws; (6) certain foreign advertising expenses; (7) certain amounts paid or incurred by a corporation in connection with the reacquisition of its stock or of the stock of any related person; or (8) certain applicable employee remuneration.

New Federal Law (IRC section 162)

Under the provision, no deduction is allowed for any settlement, payout, or attorney fees related to sexual harassment or sexual abuse if such payments are subject to a nondisclosure agreement.

Effective Dates

The provision is effective for amounts paid or incurred after the date of enactment, December 22, 2017.

[709] IRC section 162(a).

California Law (R&TC sections 17201, 17202, 17203, 17270, 17273, 17286, 18631, 24343, and 24343.7)

California conforms, under the PITL and the CTL, to the federal rules for trade or business expense deductions under IRC section 162, with modifications, as of the "specified date" of January 1, 2015,[710] but does not conform to the denial of deduction for settlements subject to nondisclosure agreements paid in connection with sexual harassment or sexual abuse.

Impact on California Revenue

Estimated Conformity Revenue Impact of Denial of Deduction for Settlements Subject to Nondisclosure Agreements Paid in Connection with Sexual Harassment or Sexual Abuse For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	$300,000	$200,000	$200,000

Section	Section Title
13308	Repeal of Deduction for Local Lobbying Expenses

Background

In General

A taxpayer generally is allowed a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business.[711] However, IRC section 162(e) denies a deduction for amounts paid or incurred in connection with (1) influencing legislation,[712] (2) participation in, or intervention in, any political campaign on behalf of (or in opposition to) any candidate for public office, (3) any attempt to influence the general public, or segments thereof, with respect to elections, legislative matters, or referendums, or (4) any direct communication with a covered executive branch official[713] in an attempt to influence the official actions or positions of such

[710] R&TC sections 17024.5 and 23051.5.
[711] IRC section 162(a).
[712] The term ''influencing legislation" means any attempt to influence any legislation through communication with any member or employee of a legislative body, or with any government official or employee who may participate in the formulation of legislation. The term ''legislation" includes actions with respect to Acts, bills, resolutions, or similar items by the Congress, any State legislature, any local council, or similar governing body, or by the public in a referendum, initiative, constitutional amendment, or similar procedure. IRC sections 162(e)(4) and 4911(e)(2).
[713] The term ''covered executive branch official" means (1) the President, (2) the Vice President, (3) any officer or employee of the White House Office of the Executive Office of the President, and the two most senior level officers of each of the other agencies in such Executive Office, (4) any individual servicing in a position in level I of the Executive

official. Expenses paid or incurred in connection with lobbying and political activities (such as research for, or preparation, planning, or coordination of, any previously described activity) also are not deductible.[714]

Exceptions

Local Legislation

Notwithstanding the above, a deduction is allowed for ordinary and necessary expenses incurred in connection with any legislation of any local council or similar governing body ("local legislation").[715] With respect to local legislation, the exception permits a deduction for amounts paid or incurred in carrying on any trade or business (1) in direct connection with appearances before, submission of statements to, or sending communications to the committees or individual members of such council or body with respect to legislation or proposed legislation of direct interest to the taxpayer, or (2) in direct connection with communication of information between the taxpayer and an organization of which the taxpayer is a member with respect to any such legislation or proposed legislation which is of direct interest to the taxpayer and such organization, and (3) that portion of the dues paid or incurred with respect to any organization of which the taxpayer is a member which is attributable to the expenses of the activities described in (1) or (2) carried on by such organization.[716]

For purposes of this exception, legislation of an Indian tribal government is treated in the same manner as local legislation.[717]

De Minimis

For taxpayers with $2,000 or less of in-house expenditures related to lobbying and political activities, a *de minimis* exception is provided that permits a deduction.[718]

<u>New Federal Law (IRC section 162)</u>

The provision repeals the exception for amounts paid or incurred related to lobbying local councils or similar governing bodies, including Indian tribal governments. Thus, the general disallowance rules applicable to lobbying and political expenditures will apply to costs incurred related to such local legislation.

<u>Effective Dates</u>

The provision applies to amounts paid or incurred on or after the date of enactment, December 22, 2017.

Schedule under section 5312 of title 5, United States Code, (5) any other individual designated by the President as having Cabinet-level status, and (6) any immediate deputy of an individual described in (4) or (5). IRC section 162(e)(6).

[714] IRC section 162(e)(5)(C).
[715] IRC section 162(e)(2)(A).
[716] IRC section 162(e)(2)(B).
[717] IRC section 162(e)(7).
[718] IRC section 162(e)(5)(B).

California Law (R&TC sections 17201, 17202, 17203, 17270, 17273, 17286, 18631, 24343, and 24343.7)

California conforms, under the PITL and the CTL, to the federal rules for trade or business expense deductions under IRC section 162, with modifications, as of the "specified date" of January 1, 2015,[719] but does not conform to the repeal of the deduction for local lobbying expenses.

Impact on California Revenue

Estimated Conformity Revenue Impact of Repeal of Deduction for Local Lobbying Expenses For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	$4,400,000	$3,900,000	$3,700,000

Section	Section Title
13309	Recharacterization of Certain Gains in the Case of Partnership Profits Interests Held in Connection with Performance of Investment Services

Background

Partnership Profits Interest for Services

A profits interest in a partnership is the right to receive future profits in the partnership but does not generally include any right to receive money or other property upon the immediate liquidation of the partnership. The treatment of the receipt of a profits interest in a partnership (sometimes referred to as a carried interest) in exchange for the performance of services has been the subject of controversy. Though courts have differed, in some instances, a taxpayer receiving a profits interest for performing services has not been taxed upon the receipt of the partnership interest.[720]

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[719] R&TC sections 17024.5 and 23051.5.

[720] Only a handful of cases have addressed this issue. Though one case required the value to be included currently, where value was easily determined by a sale of the profits interest soon after receipt (*Diamond v. Commissioner,* 56 T.C. 530 (1971), aff'd 492 F.2d 286 (7th Cir. 1974)), a more recent case concluded that partnership profits interests were not includable on receipt, because the profits interests were speculative and without fair market value (*Campbell v. Commissioner,* 943 F. 2d 815 (8th Cir. 1991)).

In 1993, the IRS, referring to the litigation of the tax treatment of receiving a partnership profits interest and the results in the cases, issued administrative guidance that the IRS generally would treat the receipt of a partnership profits interest for services as not a taxable event for the partnership or the partner.[721] Under this guidance, this treatment does not apply, however, if: (1) the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease; (2) within two years of receipt, the partner disposes of the profits interest; or (3) the profits interest is a limited partnership interest in a publicly traded partnership. More recent administrative guidance[722] clarifies that this treatment applies with respect to substantially unvested profits interests provided the service partner takes into income his distributive share of partnership income, and the partnership does not deduct any amount either on grant or on vesting of the profits interest.[723]

By contrast, a partnership capital interest received for services is includable in the partner's income under generally applicable rules relating to the receipt of property for the performance of services.[724] A partnership capital interest for this purpose is an interest that would entitle the receiving partner to a share of the proceeds if the partnership's assets were sold at fair market value and the proceeds were distributed in liquidation.[725]

Property Received for Services under IRC Section 83

In General

IRC section 83 governs the amount and timing of income and deductions attributable to transfers of property in connection with the performance of services. If property is transferred in connection with the performance of services, the person performing the services (the "service provider") generally must recognize income for the taxable year in which the property is first substantially vested (i.e., transferable or not subject to a substantial risk of forfeiture).[726] The amount

[721] Revenue Procedure 93-27 (1993-2 C.B. 343), citing the *Diamond* and *Campbell* cases, *supra.*
[722] Revenue Procedure 2001-43 (2001-2 C.B. 191). This result applies under the guidance even if the interest is substantially nonvested on the date of grant.
[723] A similar result would occur under the ''safe harbor" election under proposed regulations regarding the application of section 83 to the compensatory transfer of a partnership interest. REG-105346-03, 70 Fed. Reg. 29675 (May 24, 2005).
[724] IRC sections 61 and 83; Treasury Regulation section 1.721-1(b)(1); see *U.S. v. Frazell,* 335 F.2d 487 (5th Cir. 1964), cert. denied, 380 U.S. 961 (1965).
[725] Revenue Procedure 93-27, 1993-2 C.B. 343.
[726] The Department of Treasury has issued proposed regulations regarding the application of IRC section 83 to the compensatory transfer of a partnership interest. 70 Fed. Reg. 29675 (May 24, 2005). The proposed regulations provide that a partnership interest is "property" for purposes of IRC section 83. Thus, a compensatory transfer of a partnership interest is includible in the service provider's gross income at the time that it first becomes substantially vested (or, in the case of a substantially nonvested partnership interest, at the time of grant if an IRC section 83(b) election is made). However, because the fair market value of a compensatory partnership interest is often difficult to determine, the proposed regulations also permit a partnership and a partner to elect a safe harbor under which the fair market value of a compensatory partnership interest is treated as being equal to the liquidation value of that interest. Therefore, in the case of a true profits interest in a partnership (one under which the partner would be entitled to nothing if the partnership were liquidated immediately following the grant), under the proposed regulations, the grant of a substantially vested profits interest (or, if an IRC section 83(b) election is made, the grant of a substantially nonvested profits interest) results in no income inclusion under IRC section 83 because the fair market

includible in the service provider's income is the excess of the fair market value of the property over the amount (if any) paid for the property. A deduction is allowed to the person for whom such services are performed (the "service recipient") equal to the amount included in gross income by the service provider.[727] The deduction is allowed for the taxable year of the service recipient in which or with which ends the taxable year in which the amount is included in the service provider's income.

Property that is subject to a substantial risk of forfeiture and that is not transferable is generally referred to as "substantially nonvested." Property is subject to a substantial risk of forfeiture if the individual's right to the property is conditioned on the future performance (or refraining from performance) of substantial services. In addition, a substantial risk of forfeiture exists if the right to the property is subject to a condition other than the performance of services, provided that the condition relates to a purpose of the transfer and there is a substantial possibility that the property will be forfeited if the condition does not occur.

IRC Section 83(b) Election

Under IRC section 83(b), even if the property is substantially nonvested at the time of transfer, the service provider may nevertheless elect within 30 days of the transfer to recognize income for the taxable year of the transfer. Such an election is referred to as a "IRC section 83(b) election." The service provider makes an election by filing with the IRS a written statement that includes the fair market value of the property at the time of transfer and the amount (if any) paid for the property. The service provider must also provide a copy of the statement to the service recipient.

Passthrough Tax Treatment of Partnerships

The character of partnership items passes through to the partners, as if the items were realized directly by the partners.[728] Thus, for example, long-term capital gain of the partnership is treated as long-term capital gain in the hands of the partners.

A partner holding a partnership interest includes in income its distributive share (whether or not actually distributed) of partnership items of income and gain, including capital gain eligible for the lower tax rates. A partner's basis in the partnership interest is increased by any amount of gain thus included and is decreased by losses. These basis adjustments prevent double taxation of partnership income to the partner, preserving the partnership's tax status as a passthrough entity. Money distributed to the partner by the partnership is taxed to the extent the amount exceeds the partner's basis in the partnership interest.

Net Long-Term Capital Gain

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value of the property received by the service provider is zero. The proposed safe harbor is subject to a number of conditions. For example, the election cannot be made retroactively and must apply to all compensatory partnership transfers that occur during the period that the election is in effect.

[727] IRC section 83(h).

[728] IRC section 702.

In the case of an individual, estate, or trust, any adjusted net capital gain which otherwise would be taxed at the 10- or 15-percent rate is not taxed. Any adjusted net capital gain which otherwise would be taxed at rates over 15 percent and below 39.6 percent is taxed at a 15-percent rate. Any adjusted net capital gain which otherwise would be taxed at a 39.6-percent rate is taxed at a 20-percent rate.[729]

In general, gain or loss reflected in the value of an asset is not recognized for income tax purposes until a taxpayer disposes of the asset. On the sale or exchange of a capital asset,[730] any gain generally is included in income.

Short-term capital gain means gain from the sale or exchange of a capital asset held for not more than one year, if and to the extent such gain is taken into account in computing gross income. Net short-term capital loss means the excess of short term capital losses for the taxable year over the short-term capital gains for the taxable year.

Net long-term capital gain means the excess of long-term capital gains for the taxable year over the long-term capital losses for the taxable year.

Net capital gain is the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for the year. Gain or loss is treated as long-term if the asset is held for more than one year.

The adjusted net capital gain of an individual is the net capital gain reduced (but not below zero) by the sum of the 28-percent rate gain and the unrecaptured IRC section 1250 gain. The net capital gain is reduced by the amount of gain that the individual treats as investment income for purposes of determining the investment interest limitation.[731]

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[729] IRC section 1. Other rates apply to certain types of gain. The unrecaptured section 1250 gain is taxed at a maximum rate of 25 percent, and 28-percent rate gain is taxed at a maximum rate of 28 percent. Any amount of unrecaptured IRC section 1250 gain or 28-percent rate gain otherwise taxed at a 10- or 15-percent rate is taxed at the otherwise applicable rate. In addition, a tax is imposed on net investment income in the case of an individual, estate, or trust. In the case of an individual, the tax is 3.8 percent of the lesser of net investment income, which includes gains and dividends, or the excess of modified AGI over the threshold amount. The threshold amount is $250,000 in the case of a joint return or surviving spouse, $125,000 in the case of a married individual filing a separate return, and $200,000 in the case of any other individual.

[730] IRC section 1221. A capital asset generally means any property except (1) inventory, stock in trade, or property held primarily for sale to customers in the ordinary course of the taxpayer's trade or business, (2) depreciable or real property used in the taxpayer's trade or business, (3) specified literary or artistic property, (4) business accounts or notes receivable, (5) certain U.S. publications, (6) certain commodity derivative financial instruments, (7) hedging transactions, and (8) business supplies. In addition, the net gain from the disposition of certain property used in the taxpayer's trade or business is treated as long-term capital gain. Gain from the disposition of depreciable personal property is not treated as capital gain to the extent of all previous depreciation allowances. Gain from the disposition of depreciable real property is generally not treated as capital gain to the extent of the depreciation allowances in excess of the allowances available under the straight-line method of depreciation.

[731] IRC section 163(d).

New Federal Law (IRC section 1061)

General Rule

The provision provides for a three-year holding period in the case of certain net long-term capital gain with respect to any applicable partnership interest held by the taxpayer.

IRC section 83 (relating to property transferred in connection with performance of services) does not apply to the transfer of a partnership interest to which the provision applies.

Short-Term Capital Gain

The provision treats as short-term capital gain taxed at ordinary income rates the amount of the taxpayer's net long-term capital gain with respect to an applicable partnership interest for the taxable year that exceeds the amount of such gain calculated as if a three-year (not one-year) holding period applies. In making this calculation, the provision takes account of long-term capital losses calculated as if a three-year holding period applies.

The provision's three-year holding requirement applies notwithstanding the rules of IRC section 83 or any election in effect under IRC section 83(b). Under the provision, the fact that an individual may have included an amount in income upon acquisition of the applicable partnership interest, or that an individual may have made a IRC section 83(b) election with respect to an applicable partnership interest, does not change the three-year holding period requirement for long-term capital gain treatment with respect to the applicable partnership interest.

A special rule provides that, as provided in regulations or other guidance issued by the Secretary, this rule does not apply to income or gain attributable to any asset that is not held for portfolio investment on behalf of third party investors. Third party investor means a person (1) who holds an interest in the partnership that is not property held in connection with an applicable trade or business (defined below) with respect to that person, and (2) who is not and has not been actively engaged in directly or indirectly providing substantial services for the partnership or any applicable trade or business (and is (or was) not related to a person so engaged). A related person for this purpose is a family member (within the meaning of attribution rules[732]) or colleague, that is a person who performed a service within the current calendar year or the preceding three calendar years in any applicable trade or business in which or for which the taxpayer performed a service.

Applicable Partnership Interest

An applicable partnership interest is any interest in a partnership that, directly or indirectly, is transferred to (or held by) the taxpayer in connection with performance of services in any applicable trade or business. The services may be performed by the taxpayer or by any other related person or persons in any applicable trade or business. It is intended that partnership interests shall not fail to be treated as transferred or held in connection with the performance of services merely because the taxpayer also made contributions to the partnership, and the

[732] IRC section 318(a)(1).

Treasury Department is directed to provide guidance implementing this intent. An applicable partnership interest does not include an interest held by a person who is employed by another entity that is conducting a trade or business (which is not an applicable trade or business) and who provides services only to the other entity.

An applicable partnership interest does not include an interest in a partnership directly or indirectly held by a corporation. For example, if two corporations form a partnership to conduct a joint venture for developing and marketing a pharmaceutical product, the partnership interests held by the two corporations are not applicable partnership interests.

An applicable partnership interest does not include any capital interest in a partnership giving the taxpayer a right to share in partnership capital commensurate with the amount of capital contributed (as of the time the partnership interest was received), or commensurate with the value of the partnership interest that is taxed under IRC section 83 on receipt or vesting of the partnership interest. For example, in the case of a partner who holds a capital interest in the partnership with respect to capital he or she contributed to the partnership, if the partnership agreement provides that the partner's share of partnership capital is commensurate with the amount of capital he or she contributed (as of the time the partnership interest was received) compared to total partnership capital, the partnership interest is not an applicable partnership interest to that extent.

Applicable Trade or Business

An applicable trade or business means any activity (regardless of whether the activity is conducted in one or more entities) that consists in whole or in part of the following: (1) raising or returning capital, and either (2) investing in (or disposing of) specified assets (or identifying specified assets for investing or disposition), or (3) developing specified assets.

Developing specified assets takes place, for example, if it is represented to investors, lenders, regulators, or others that the value, price, or yield of a portfolio business may be enhanced or increased in connection with choices or actions of a service provider or of others acting in concert with or at the direction of a service provider. Services performed as an employee of an applicable trade or business are treated as performed in an applicable trade or business for purposes of this rule. Merely voting shares owned does not amount to development; for example, a mutual fund that merely votes proxies received with respect to shares of stock it holds is not engaged in development.

Specified Assets

Under the provision, specified assets means securities (generally as defined under rules for mark-to-market accounting for securities dealers), commodities (as defined under rules for mark-to-market accounting for commodities dealers), real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to such securities, commodities, real estate, cash or cash equivalents, as well as an interest in a partnership to the extent of the partnership's proportionate interest in the foregoing. A security for this purpose means any (1) share of corporate stock, (2) partnership interest or beneficial ownership interest in a widely held or publicly traded partnership or trust, (3) note, bond, debenture, or other evidence of indebtedness, (4) interest rate, currency, or equity notional principal contract, (5) interest in, or derivative financial instrument in, any such security or any currency (regardless of whether IRC section 1256 applies to the contract), and (6) position that is not such a security and is a hedge with respect to such a security and is clearly identified. A commodity for this purpose means any (1) commodity that is actively traded, (2) notional principal contract with respect to such a commodity, (3) interest in, or derivative financial instrument in, such a commodity or notional principal contract, or (4) position that is not such a commodity and is a hedge with respect to such a commodity and is clearly identified. For purposes of the provision, real estate held for rental or investment does not include, for example, real estate on which the holder operates an active farm.

A partnership interest, for purposes of determining the proportionate interest of a partnership in any specified asset, includes any partnership interest that is not otherwise treated as a security for purposes of the provision (for example, an interest in a partnership that is not widely held or publicly traded). For example, assume that a hedge fund acquires an interest in an operating business conducted in the form of a non-publicly traded partnership that is not widely held; the partnership interest is a specified asset for purposes of the provision.

Transfer of Applicable Partnership Interest to Related Person

If a taxpayer transfers any applicable partnership interest, directly or indirectly, to a person related to the taxpayer, then the taxpayer includes in gross income as short-term capital gain so much of the taxpayer's net long-term capital gain attributable to the sale or exchange of an asset held for not more than three years as is allocable to the interest. The amount included as short-term capital gain on the transfer is reduced by the amount treated as short-term capital gain on the transfer for the taxable year under the general rule of the provision (that is, amounts are not double-counted). A related person for this purpose is a family member (within the meaning of attribution rules[733]) or colleague, that is a person who performed a service within the current calendar year or the preceding three calendar years in any applicable trade or business in which or for which the taxpayer performed a service.

Reporting Requirement

The Secretary is directed to require reporting (at the time and in the manner determined by the Secretary) necessary to carry out the purposes of the provision.

Regulatory Authority

The Treasury Department is directed to issue regulations or other guidance necessary or appropriate to carry out the purposes of this provision.

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[733] IRC section 318(a)(1).

Effective Dates

The provision applies to taxable years beginning after December 31, 2017.

California Law (R&TC section 18031)

California conforms, under the PITL, to Subchapter O of Chapter 1 of Subtitle A of the IRC, relating to gain or loss on the disposition of property, which includes sections 1001-1092, with modifications, as of the "specified date" of January 1, 2015,[734] but does not conform to the new federal provision regarding recharacterization of certain gains in the case of partnership profits interests held in connection with performance of investment services.

California does not conform, under the CTL, to certain gains in the case of partnership profits interests held in connection with performance of investment services, and has no similar stand-alone provision. California does not have preferential rates relating the capital gains, although the netting rules of federal law apply for California purposes, ordinary and capital gain tax rates are the same.

Impact on California Revenue

Estimated Conformity Revenue Impact of Repeal of Deduction for Local Lobbying Expenses For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
$0	$0	$0	$0

Section	Section Title
13310	Prohibition on Cash, Gift Cards, and Other Nontangible Personal Property as Employee Achievement Awards

Background

An employer's deduction for the cost of an employee achievement award is limited to a certain amount.[735] Employee achievement awards that are deductible by an employer (or would be deductible but for the fact that the employer is a tax-exempt organization) are excludable from an

[734] R&TC sections 17024.5 and 23051.5.
[735] IRC section 274(j).

employee's gross income.[736] Amounts that are excludible from gross income under IRC section 74(c) for income tax purposes are also excluded from wages for employment tax purposes.

Employee achievement awards are excludable to the extent the employer can deduct the cost of the award, generally limited to $400 for any one employee or $1,600 for a “qualified plan award.” An employee achievement award is an item of tangible personal property given to an employee in recognition of either length of service or safety achievement and presented as part of a meaningful presentation.

New Federal Law (IRC section 274)

The provision repeals the deduction limitation for employee achievement awards. The provision adds a definition of “tangible personal property” that may be considered a deductible employee achievement award. It provides that tangible personal property shall not include cash, cash equivalents, gift cards, gift coupons or gift certificates (other than arrangements conferring only the right to select and receive tangible personal property from a limited array of such items pre-selected or pre-approved by the employer), or vacations, meals, lodging, tickets to theater or sporting events, stocks, bonds, other securities, and other similar items. No inference is intended that this is a change from present law and guidance.

Effective Dates

The provision applies to amounts paid or incurred after December 31, 2017.

California Law (R&TC sections 17201 and 24443)

California conforms, under the PITL and the CTL, to the federal rules for the disallowance of certain entertainment, etc., expenses under IRC section 274, as of the “specified date” of January 1, 2015,[737] but does not conform to the prohibition on deductions for cash, gift cards, and other nontangible personal property as employee achievement awards.

[736] IRC section 74(c).
[737] R&TC sections 17024.5 and 23051.5.

Impact on California Revenue

Estimated Conformity Revenue Impact of Prohibition on Cash, Gift Cards, and Other Nontangible Personal Property as Employee Achievement Awards For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	$450,000	$200,000	$200,000

Section	Section Title
13311	Elimination of Deduction for Living Expenses Incurred by Members of Congress

Background

Under IRC section 162(a)(2), away-from-home travel costs can qualify as deductible trade or business or production of income expenses, while the cost of travel for personal reasons is not deductible. There are limits on the deductibility of certain costs of combined business and pleasure trips. There are also special limits on the deductibility of foreign travel, including foreign meetings and conventions.

An individual's tax home is their place of business, employment, station or post of duty, even though their family residence is in a different place.[738]

For income tax purposes, the place of residence of a member of Congress (including any delegate or resident commissioner) within the state, congressional district or possession which he represents is considered to be the member's tax home.[739] Members are considered away from home while in Washington on congressional business;[740] however, deductions for living expenses away from home cannot exceed $3,000 in any tax year.[741]

A member's living expenses in Washington include that portion of the cost of meals and the cost of lodging which is attributable to the member individually. The cost of meals includes expenses of preparation and serving. The cost of lodging includes rentals, care of premises, household laundry and utilities, interest, taxes and depreciation on houses or household equipment and furnishings. Personal expenses of the member, such as laundry, are not deductible. If a member's family lives with the member in Washington, expenses must be allocated to reflect the deductible portion attributable to the member.

[738] IRS Publication 463, (2016), p. 3.
[739] IRC section 162(a).
[740] Revenue Ruling 73-468, 1973-2 CB 77.
[741] IRC section 162(a).

New Federal Law (IRC section 162)

The provision prohibits members of Congress from deducting living expenses when they are away from home, eliminating the $3,000 allowance.

Effective Dates

The provision is effective for taxable years beginning after the date of enactment, December 22, 2017.

California Law (R&TC sections 17201, 17202, 17203, 17270, 17273, 17286, 24343, and 24343.7)

California conforms, under the PITL and the CTL, to the federal rules for trade or business expense deductions under IRC section 162, with modifications, as of the "specified date" of January 1, 2015,[742] but does not conform to the elimination of deductions for living expenses incurred by members of congress.

California modifies IRC section 162(a)(2)[743] to provide that the place of residence of a member of the Legislature within the district represented shall be considered their tax home.

Impact on California Revenue

Estimated Conformity Revenue Impact of Elimination of Deduction for Living Expenses Incurred by Members of Congress For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	$400,000	$200,000	$200,000

[742] R&TC sections 17024.5 and 23051.5.
[743] R&TC section 17270(a)(1).

Section	Section Title
13312	Certain Contributions by Governmental Entities Not Treated as Contributions to Capital

Background

The gross income of a corporation does not include any contribution to its capital.[744] For purposes of this rule, a contribution to the capital of a corporation does not include any contribution in aid of construction or any other contribution from a customer or potential customer.[745] A special rule allows certain contributions in aid of construction received by a regulated public utility that provides water or sewerage disposal services to be treated as a tax-free contribution to the capital of the utility.[746] No deduction or credit is allowed for, or by reason of, any expenditure that constitutes a contribution that is treated as a tax-free contribution to the capital of the utility.[747]

If property is acquired by a corporation as a contribution to capital and is not contributed by a shareholder as such, the adjusted basis of the property is zero.[748] If the contribution consists of money, the corporation must first reduce the basis of any property acquired with the contributed money within the following 12-month period, and then reduce the basis of other property held by the corporation.[749] Similarly, the adjusted basis of any property acquired by a utility with a contribution in aid of construction is zero.[750]

New Federal Law (IRC section 118)

The provision broadens the exceptions from gross income by way of the capital contribution rules. Thus, a "contribution to the capital of the taxpayer" does not include, 1) any contribution in aid of construction or any other contribution as a customer or potential customer, and 2) any contribution by any governmental entity or civic group (other than contribution made by a shareholder in that capacity).

In addition, the regulated public utility exception and the special statute of limitations period are repealed.

Contributions in exchange for fair market value, determined without regard to discounts for lack of control and the effect of limited liquidity on valuation, and pro rata contributions by shareholders that are made without the issuance of additional stock are excluded from gross income, and are therefore not taxable. In addition, a municipal tax abatement for locating a business in a particular municipality is not a contribution and is not taxable.

[744] IRC section 118(a).
[745] IRC section 118(b).
[746] IRC section 118(c)(1).
[747] IRC section 118(c)(4).
[748] IRC section 362(c)(1).
[749] IRC section 362(c)(2). See also Treasury Regulation section 1.362-2.
[750] IRC section 118(c)(4).

The Secretary of the Treasury is directed to issue regulations or other guidance as may be necessary or appropriate to implement these rules, including regulations or other guidance for determining whether any contribution is a contribution in aid of construction.

Effective Dates

The provision applies to contributions made after the date of enactment, December 22, 2017. However, the provision shall not apply to any contribution made after the date of enactment by a governmental entity pursuant to a master development plan that has been approved prior to such date by a governmental entity.

California Law (R&TC section 24325)

California law conforms, under the CTL, to federal rules related to contributions of capital to a corporation, as of the "specified date" of January 1, 2015,[751] but California does not conform to the federal modifications related to certain contributions in aid of construction by customers or potential customers or contributions by governmental entities that are not treated as contributions to capital.

Impact on California Revenue

Estimated Conformity Revenue Impact of Certain Contributions by Governmental Entities Not Treated as Contributions to Capital For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	$8,100,000	$13,000,000	$21,000,000

Section	Section Title
13313	Repeal of Rollover of Publicly-Traded Securities Gain into Specialized Small Business Investment Companies

Background

A corporation or individual may elect to roll over tax-free any capital gain realized on the sale of publicly-traded securities to the extent of the taxpayer's cost of purchasing common stock or a partnership interest in a specialized small business investment company within 60 days of the sale.[752] The amount of gain that an individual may elect to roll over under this provision for a

[751] R&TC section 23051.5.
[752] IRC section 1044(a).

taxable year is limited to (1) $50,000 or (2) $500,000 reduced by the gain previously excluded under this provision.[753] For corporations, these limits are $250,000 and $1 million, respectively.[754]

New Federal Law (IRC section 1044)

The provision repeals the election described above to roll over tax-free capital gain realized on the sale of publicly-traded securities.

Effective Dates

The provision applies to sales after December 31, 2017.

California Law (R&TC sections 18031, 18044, and 24956)

California conforms, under the PITL and the CTL, to the federal election to roll over tax-free capital gain realized on the sale of publicly-traded securities under IRC section 1044, as of the specified date of January 1, 2015.[755][756] However, under the PITL and the CTL, the federal election to roll over tax-free capital gain realized on the sale of publicly-traded securities does not apply to any taxable year in which those provisions are inapplicable for federal purposes. As a result, California effectively conforms to the federal repeal of this provision since the rollover is not available for California purposes because it is inapplicable for federal purposes.

Impact on California Revenue

Baseline.

Section	Section Title
13314	Certain Self-Created Property Not Treated as a Capital Asset

Background

In general, property held by a taxpayer (whether or not connected with his trade or business) is considered a capital asset.[757] Certain assets, however, are specifically excluded from the definition of capital asset. Such excluded assets are: inventory property, property of a character

[753] IRC section 1044(b)(1).
[754] IRC section 1044(b)(2).
[755] R&TC sections 17024.5 and 23051.5.
[756] R&TC sections 18044 and 24956.
[757] IRC section 1221(a).

subject to depreciation (including real property),[758] certain self-created intangibles, accounts or notes receivable acquired in the ordinary course of business (*e.g.,* for providing services or selling property), publications of the U.S. Government received by a taxpayer other than by purchase at the price offered to the public, commodities derivative financial instruments held by a commodities derivatives dealer unless established to the satisfaction of the Secretary that any such instrument has no connection to the activities of such dealer as a dealer and clearly identified as such before the close of the day on which it was acquired, originated, or entered into, hedging transactions clearly identified as such, and supplies regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer.[759]

Self-created intangibles subject to the exception are copyrights, literary, musical, or artistic compositions, letters or memoranda, or similar property which is held either by the taxpayer who created the property, or (in the case of a letter, memorandum, or similar property) a taxpayer for whom the property was produced.[760] For the purpose of determining gain, a taxpayer with a substituted or transferred basis from the taxpayer who created the property, or for whom the property was created, also is subject to the exception.[761] However, a taxpayer may elect to treat musical compositions and copyrights in musical works as capital assets.[762]

Since the intent of Congress is that profits and losses arising from everyday business operations be characterized as ordinary income and loss, the general definition of capital asset is narrowly applied and the categories of exclusions are broadly interpreted.[763]

<u>New Federal Law (IRC section 1221)</u>

This provision amends IRC section 1221(a)(3), resulting in the exclusion of a patent, invention, model or design (whether or not patented), and a secret formula or process which is held either by the taxpayer who created the property or a taxpayer with a substituted or transferred basis from the taxpayer who created the property (or for whom the property was created) from the definition of a "capital asset." Thus, gains or losses from the sale or exchange of a patent, invention, model or design (whether or not patented), or a secret formula or process which is held either by the taxpayer who created the property or a taxpayer with a substituted or transferred basis from the taxpayer who created the property (or for whom the property was created) will not receive capital gain treatment.

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[758] The net gain from the sale, exchange, or involuntary conversion of certain property used in the taxpayer's trade or business (in excess of depreciation recapture) is treated as long-term capital gain. IRC section 1231. However, net gain from such property is treated as ordinary income to the extent that losses from such property in the previous five years were treated as ordinary losses. IRC section 1231(c).
[759] IRC section 1221(a)(1)-(8).
[760] IRC section 1221(a)(3)(A) and (B).
[761] IRC section 1221(a)(3)(C).
[762] IRC section 1221(b)(3). Thus, if a taxpayer who owns musical compositions or copyrights in musical works that the taxpayer created (or if a taxpayer to which the musical compositions or copyrights have been transferred by the works' creator in a substituted basis transaction) elects the application of this provision, gain from a sale of the compositions or copyrights is treated as capital gain, not ordinary income.
[763] *Corn Products Refining Co. v. Commissioner,* 350 U.S. 46, 52 (1955).

Effective Dates

The provision applies to dispositions after December 31, 2017.

California Law (R&TC sections 18151 and 24990)

California law conforms, under the PITL and the CTL, to the federal definition of a capital asset under IRC section 1221, as of the "specified date" of January 1, 2015,[764] but does not conform to the exclusion of a patent, invention, model or design (whether or not patented), and a secret formula or process held by the taxpayer who created the property (and certain other taxpayers) from the definition of a capital asset.

Impact on California Revenue

Not applicable.

Part V—Business Credits

Section	Section Title
13401	Modification of Orphan Drug Credit

Background

IRC section 45C provides a 50-percent business tax credit for qualified clinical testing expenses incurred in testing of certain drugs for rare diseases or conditions, generally referred to as "orphan drugs." Qualified clinical testing expenses are costs incurred to test an orphan drug after the drug has been approved for human testing by the Food and Drug Administration (FDA) but before the drug has been approved for sale by the FDA.[765] A rare disease or condition is defined as one that (1) affects fewer than 200,000 persons in the United States, or (2) affects more than 200,000 persons, but for which there is no reasonable expectation that businesses could recoup the costs of developing a drug for such disease or condition from sales in the United States of the drug.[766]

Amounts included in computing the credit under this section are excluded from the computation of the research credit under IRC section 41.[767]

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[764] R&TC sections 17024.5 and 23051.5.
[765] IRC section 45C(b).
[766] IRC section 45C(d).
[767] IRC section 45C(c).

New Federal Law (IRC section 45C)

The provision reduces the credit rate to 25 percent of qualified clinical testing expenses.

Effective Dates

The provision applies to taxable years beginning after December 31, 2017.

California Law

California does not conform to IRC section 45C, relating to the orphan drug credit, and has no comparable credit.

Impact on California Revenue

Not applicable.

Section	Section Title
13402	Rehabilitation Credit Limited to Certified Historic Structures

Background

Present law provides a two-tier tax credit for rehabilitation expenditures.

A 20-percent credit is provided for qualified rehabilitation expenditures with respect to a certified historic structure. For this purpose, a certified historic structure means any building that is listed in the National Register, or that is located in a registered historic district and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.

A 10-percent credit is provided for qualified rehabilitation expenditures with respect to a qualified rehabilitated building, which generally means a building that was first placed in service before 1936. The pre-1936 building must meet requirements with respect to retention of existing external walls and internal structural framework of the building in order for expenditures with respect to it to qualify for the 10-percent credit. A building is treated as having met the substantial rehabilitation requirement under the 10-percent credit only if the rehabilitation expenditures during the 24-month period selected by the taxpayer and ending within the taxable year exceed the greater of (1) the adjusted basis of the building (and its structural components), or (2) $5,000.

The provision requires the use of straight-line depreciation or the alternative depreciation system in order for rehabilitation expenditures to be treated as qualified under the provision.

New Federal Law (IRC section 47)

The provision repeals the 10-percent credit for pre-1936 buildings and retains the 20-percent credit for qualified rehabilitation expenditures with respect to a certified historic structure, with a modification. Under the provision, the credit allowable for a taxable year during the five-year period beginning in the taxable year in which the qualified rehabilitated building is placed in service is an amount equal to the ratable share. The ratable share for a taxable year during the five-year period is the amount equal to 20 percent of the qualified rehabilitation expenditures for the building, as allocated ratably to each taxable year during the five-year period. It is intended that the sum of the ratable shares for the taxable years during the five-year period does not exceed 100 percent of the credit for qualified rehabilitation expenditures for the qualified rehabilitated building.

Effective Dates

The provision applies to amounts paid or incurred after December 31, 2017. A transition rule provides that in the case of qualified rehabilitation expenditures (for either a certified historic structure or a pre-1936 building), with respect to any building owned or leased (as provided under present law) by the taxpayer at all times on and after January 1, 2018, the 24-month period selected by the taxpayer (IRC section 47(c)(1)(C)(i)), or the 60-month period selected by the taxpayer under the rule for phased rehabilitation (IRC section 47(c)(1)(C)(ii)), is to begin not later than the end of the 180-day period beginning on the date of the enactment of the Act, and the amendments made by the provision apply to such expenditures paid or incurred after the end of the taxable year in which such 24-month or 60-month period ends.

California Law

California does not conform to IRC section 47, relating to the rehabilitation credit, and has no comparable credit.

Impact on California Revenue

Not applicable.

Section	Section Title
13403	Employer Credit for Paid Family and Medical Leave

Background

Present law does not provide a credit to employers for compensation paid to employees while on leave.

New Federal Law (IRC section 45S)

The provision allows eligible employers to claim a general business credit equal to 12.5 percent of the amount of wages paid to qualifying employees during any period in which such employees are on family and medical leave if the rate of payment under the program is 50 percent of the wages normally paid to an employee. The credit is increased by 0.25 percentage points (but not above 25 percent) for each percentage point by which the rate of payment exceeds 50 percent. The maximum amount of family and medical leave that may be taken into account with respect to any employee for any taxable year is 12 weeks.

An eligible employer is one who has in place a written policy that allows all qualifying full-time employees not less than two weeks of annual paid family and medical leave, and who allows all less-than-full-time qualifying employees a commensurate amount of leave in proportion to the part-time employee's expected work hours. For purposes of this requirement, leave paid for by a State or local government is not taken into account. A "qualifying employee" means any employee as defined in section 3(e) of the Fair Labor Standards Act of 1938 who has been employed by the employer for one year or more, and who for the preceding year, had compensation not in excess of 60 percent of the compensation threshold for highly compensated employees.[768] The Secretary will make determinations as to whether an employer or an employee satisfies the applicable requirements for an eligible employer or qualifying employee, based on information provided by the employer.

"Family and medical leave" is defined as leave described under sections 102(a)(1)(a)-(e) or 102(a)(3) of the Family and Medical Leave Act of 1993.[769] If an employer provides paid leave as vacation leave, personal leave, or other medical or sick leave, this paid leave would not be considered to be family and medical leave.

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[768] IRC section 414(g)(1)(B) ($120,000 for 2017).

[769] In order to be an eligible employer, an employer must provide certain protections applicable under the Family and Medical Leave Act of 1993, regardless of whether they otherwise apply. Specifically, the employer must provide paid family and medical leave in compliance with a policy which ensures that the employer will not interfere with, restrain, or deny the exercise of or the attempt to exercise, any right provided under the policy and will not discharge or in any other manner discriminate against any individual for opposing any practice prohibited by the policy.

Effective Dates

The provision is generally effective for wages paid in taxable years beginning after December 31, 2017, and would not apply to wages paid in taxable years beginning after December 31, 2019.

California Law

California does not conform to new IRC section 45S, relating to the new employer credit for paid family and medical leave, and has no comparable credit.

California extends disability compensation to people who take time off work to care for a seriously ill child, spouse, parent, domestic partner, or to bond with a new baby or adopted child. Because the benefits paid are in the nature of unemployment compensation, California law considers it nontaxable income for state purposes. The Paid Family Leave program is part of the State Disability Insurance program administered by the Employment Development Department (EDD).

Impact on California Revenue

Not applicable.

Section	Section Title
13404	Repeal of Tax Credit Bonds

Background

In General

Tax-credit bonds provide tax credits to investors to replace a prescribed portion of the interest cost. The borrowing subsidy generally is measured by reference to the credit rate set by the Treasury Department. Current tax-credit bonds include qualified tax-credit bonds, which have certain common general requirements, and include new clean renewable energy bonds, qualified energy conservation bonds, qualified zone academy bonds, and qualified school construction bonds.[770]

Qualified Tax-Credit Bonds

General Rules Applicable to Qualified Tax-Credit Bonds[771]

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770 The authority to issue two other types of tax-credit bonds, recovery zone economic development bonds and Build America Bonds, expired on January 1, 2011.

771 Certain other rules apply to qualified tax-credit bonds, such as maturity limitations, reporting requirements, spending rules, and rules relating to arbitrage. Separate rules apply in the case of tax-credit bonds which are not qualified tax-credit bonds (*i.e.*, “recovery zone economic development bonds,” and “Build America Bonds”).

Unlike tax-exempt bonds, qualified tax-credit bonds generally are not interest-bearing obligations. Rather, the taxpayer holding a qualified tax-credit bond on a credit allowance date is entitled to a tax credit. The amount of the credit is determined by multiplying the bond's credit rate by the face amount on the holder's bond. The credit rate for an issue of qualified tax-credit bonds is determined by the Secretary and is estimated to be a rate that permits issuance of the qualified tax-credit bonds without discount and interest cost to the qualified issuer.[772] The credit accrues quarterly and is includible in gross income (as if it were an interest payment on the bond), and can be claimed against regular income tax liability and alternative minimum tax (AMT) liability. Unused credits may be carried forward to succeeding taxable years. In addition, credits may be separated from the ownership of the underlying bond similar to how interest coupons can be stripped for interest-bearing bonds.

New Clean Renewable Energy Bonds

New clean renewable energy bonds (New CREBs) may be issued by qualified issuers to finance qualified renewable energy facilities.[773] Qualified renewable energy facilities are facilities that: (1) qualify for the tax credit under IRC section 45 (other than Indian coal and refined coal production facilities), without regard to the placed-in-service date requirements of that section; and (2) are owned by a public power provider, governmental body, or cooperative electric company.

The term "qualified issuers" includes: (1) public power providers; (2) a governmental body; (3) cooperative electric companies; (4) a not-for-profit electric utility that has received a loan or guarantee under the Rural Electrification Act; and (5) clean renewable energy bond lenders. There was originally a national limitation for New CREBs of $800 million. The national limitation was then increased by an additional $1.6 billion in 2009. As with other tax-credit bonds, a taxpayer holding New CREBs on a credit allowance date is entitled to a tax credit. However, the credit rate on New CREBs is set by the Secretary at a rate that is 70 percent of the rate that would permit issuance of such bonds without discount and interest cost to the issuer.[774]

Qualified Energy Conservation Bonds

Qualified energy conservation bonds may be used to finance qualified conservation purposes. The term "qualified conservation purpose" means:

Capital expenditures incurred for purposes of: (a) reducing energy consumption in publicly owned buildings by at least 20 percent; (b) implementing green community programs;[775] (c) rural

[772] However, for new clean renewable energy bonds and qualified energy conservation bonds, the applicable credit rate is 70 percent of the otherwise applicable rate.
[773] IRC section 54C.
[774] Given the differences in credit quality and other characteristics of individual issuers, the Secretary cannot set credit rates in a manner that will allow each issuer to issue tax-credit bonds at par.
[775] Capital expenditures to implement green community programs include grants, loans, and other repayment mechanisms to implement such programs. For example, States may issue these tax credit bonds to finance retrofits of existing private buildings through loans and/or grants to individual homeowners or businesses, or through other repayment mechanisms. Other repayment mechanisms can include periodic fees assessed on a government bill or

development involving the production of electricity from renewable energy resources; or (d) any facility eligible for the production tax credit under IRC section 45 (other than Indian coal and refined coal production facilities);

Expenditures with respect to facilities or grants that support research in: (a) development of cellulosic ethanol or other nonfossil fuels; (b) technologies for the capture and sequestration of carbon dioxide produced through the use of fossil fuels; increasing the efficiency of existing technologies for producing nonfossil fuels; automobile battery technologies and other technologies to reduce fossil fuel consumption in transportation; and (e) technologies to reduce energy use in buildings;

Mass commuting facilities and related facilities that reduce the consumption of energy, including expenditures to reduce pollution from vehicles used for mass commuting;

Demonstration projects designed to promote the commercialization of: (a) green building technology; (b) conversion of agricultural waste for use in the production of fuel or otherwise; (c) advanced battery manufacturing technologies; (d) technologies to reduce peak-use of electricity; and (e) technologies for the capture and sequestration of carbon dioxide emitted from combusting fossil fuels in order to produce electricity; and

Public education campaigns to promote energy efficiency (other than movies, concerts, and other events held primarily for entertainment purposes).

There was originally a national limitation on qualified energy conservation bonds of $800 million. The national limitation was then increased by an additional $2.4 billion in 2009. As with other qualified tax credit bonds, the taxpayer holding qualified energy conservation bonds on a credit allowance date is entitled to a tax credit. The credit rate on the bonds is set by the Secretary at a rate that is 70 percent of the rate that would permit issuance of such bonds without discount and interest cost to the issuer.[776]

Qualified Zone Academy Bonds (QZABs)

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

A total of $400 million of QZABs has been authorized to be issued annually in calendar years 1998 through 2008. The authorization was increased to $1.4 billion for calendar year 2009, and also for calendar year 2010. For each of the calendar years 2011 through 2016, the authorization was set at $400 million.

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utility bill that approximates the energy savings of energy efficiency or conservation retrofits. Retrofits can include heating, cooling, lighting, water-saving, storm water-reducing, or other efficiency measures.

[776] Given the differences in credit quality and other characteristics of individual issuers, the Secretary cannot set credit rates in a manner that will allow each issuer to issue tax credit bonds at par.

Qualified School Construction Bonds

Qualified school construction bonds must meet three requirements: (1) 100 percent of the available project proceeds of the bond issue is used for the construction, rehabilitation, or repair of a public school facility or for the acquisition of land on which such a bond-financed facility is to be constructed; (2) the bonds are issued by a State or local government within which such school is located; and (3) the issuer designates such bonds as a qualified school construction bond.

There is a national limitation on qualified school construction bonds of $11 billion for calendar years 2009 and 2010, and zero after 2010. If an amount allocated is unused for a calendar year, it may be carried forward to the following and subsequent calendar years. Under a separate special rule, the Secretary of the Interior may allocate $200 million of school construction bond authority for Indian schools.

Direct-Pay Bonds and Expired Tax-Credit Bond Provisions

The IRC provides that an issuer may elect to issue certain tax credit bonds as "direct-pay bonds." Instead of a credit to the holder, with a "direct-pay bond" the Federal government pays the issuer a percentage of the interest on the bonds. The following tax credit bonds may be issued as direct-pay bonds: new clean renewable energy bonds, qualified energy conservation bonds, and qualified school construction bonds. Qualified zone academy bonds may not be issued as direct-pay using any national zone academy bond allocation for calendar years after 2011 or any carryforward of such allocations. The ability to issue Build America Bonds and Recovery Zone bonds, which have direct-pay features, has expired.

<u>New Federal Law (IRC sections 54, 54A, 54B, 54C, 54D, 54E, 54F, 54AA, and 6431)</u>

The provision prospectively repeals authority to issue tax-credit bonds and direct-pay bonds.

<u>Effective Dates</u>

The provision applies to bonds issued after December 31, 2017.

<u>California Law</u>

California does not conform to the federal tax credit bond provisions under subparts H, I, and J of part IV of subchapter A of chapter 1 of the IRC, or the credit for qualified bonds allowed to an issuer under IRC section 6431.

Impact on California Revenue

Not applicable.

Part VI—Provisions Related to Specific Entities and Industries
Subpart A—Partnership Provisions

Section	Section Title
13501	Treatment of Gain or Loss of Foreign Persons from Sale or Exchange of Interests in Partnerships Engaged In Trade or Business within the United States

Background

In General

A partnership generally is not treated as a taxable entity, but rather, income of the partnership is taken into account on the tax returns of the partners. The character (as capital or ordinary) of partnership items passes through to the partners as if the items were realized directly by the partners.[777] A partner holding a partnership interest includes in income its distributive share (whether or not actually distributed) of partnership items of income and gain, including capital gain eligible for the lower tax rates, and deducts its distributive share of partnership items of deduction and loss. A partner's basis in the partnership interest is increased by any amount of gain and decreased by any amount of losses thus included. These basis adjustments prevent double taxation of partnership income to the partner. Money distributed to the partner by the partnership is taxed to the extent the amount exceeds the partner's basis in the partnership interest.

Gain or loss from the sale or exchange of a partnership interest generally is treated as gain or loss from the sale or exchange of a capital asset.[778] However, the amount of money and the fair market value of property received in the exchange that represent the partner's share of certain ordinary income-producing assets of the partnership give rise to ordinary income rather than capital gain.[779] In general, a partnership does not adjust the basis of partnership property following the transfer of a partnership interest unless either the partnership has made a one-time election to do so,[780] or the partnership has a substantial built-in loss immediately after the transfer.[781] If an election is in effect or the partnership has a substantial built-in loss immediately after the transfer, adjustments are made with respect to the transferee partner.

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[777] IRC section 702.
[778] IRC section 741; *Pollack v. Commissioner*, 69 T.C. 142 (1977).
[779] IRC section 751(a). These ordinary income-producing assets are unrealized receivables of the partnership or inventory items of the partnership ("751 assets").
[780] IRC section 754.
[781] IRC section 743(a).

These adjustments are to account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee partner's basis in its partnership interest.[782] The effect of the adjustments on the basis of partnership property is to approximate the result of a direct purchase of the property by the transferee partner.

Source of Gain or Loss on Transfer of a Partnership Interest

A foreign person that is engaged in a trade or business in the United States is taxed on income that is "effectively connected" with the conduct of that trade or business ("effectively connected gain or loss").[783] Partners in a partnership are treated as engaged in the conduct of a trade or business within the United States if the partnership is so engaged.[784] Any gross income derived by the foreign person that is not effectively connected with the person's U.S. business is not taken into account in determining the rates of U.S. tax applicable to the person's income from the business.[785]

Among the factors taken into account in determining whether income, gain, or loss is effectively connected gain or loss are the extent to which the income, gain, or loss is derived from assets used in or held for use in the conduct of the U.S. trade or business and whether the activities of the trade or business were a material factor in the realization of the income, gain, or loss (the "asset use" and "business activities" tests).[786] In determining whether the asset use or business activities tests are met, due regard is given to whether such assets or such income, gain, or loss were accounted for through such trade or business. Thus, notwithstanding the general rule that source of gain or loss from the sale or exchange of personal property is generally determined by the residence of the seller,[787] a foreign partner may have effectively connected income by reason of the asset use or business activities of the partnership in which he is an investor.

Special rules apply to treat gain or loss from disposition of U.S. real property interests as effectively connected with the conduct of a U.S. trade or business.[788] To the extent that consideration received by the nonresident alien or foreign corporation for all or part of its interest in a partnership is attributable to a U.S. real property interest, that consideration is considered to be received from the sale or exchange in the United States of such property.[789] In certain circumstances, gain attributable to sales of U.S. real property interests may be subject to withholding tax of ten percent of the amount realized on the transfer.[790]

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[782] IRC section 743(b).
[783] IRC sections 871(b), 864(c), 882.
[784] IRC section 875.
[785] IRC sections 871(b)(2), and 882(a)(2). Non-business income received by foreign persons from U.S. sources is generally subject to tax on a gross basis at a rate of 30 percent, and is collected by withholding at the source of the payment. The income of non-resident aliens or foreign corporations that is subject to tax at a rate of 30-percent is fixed, determinable, annual or periodical income that is not effectively connected with the conduct of a U.S. trade or business.
[786] IRC section 864(c)(2).
[787] IRC section 865(a).
[788] IRC section 897(a), (g).
[789] IRC section 897(g).
[790] IRC section 1445(e)(5). Temporary Treasury Regulation section 1.1445-11T(b),(d).

Under a 1991 revenue ruling, in determining the source of gain or loss from the sale or exchange of an interest in a foreign partnership, the Internal Revenue Service (IRS) applied the asset-use test and business activities test at the partnership level to determine the extent to which income derived from the sale or exchange is effectively connected with that U.S. business.[791] Under the ruling, if there is unrealized gain or loss in partnership assets that would be treated as effectively connected with the conduct of a U.S. trade or business if those assets were sold by the partnership, some or all of the foreign person's gain or loss from the sale or exchange of a partnership interest may be treated as effectively connected with the conduct of a U.S. trade or business. However, a 2017 Tax Court case rejects the logic of the ruling and instead holds that, generally, gain or loss on sale or exchange by a foreign person of an interest in a partnership that is engaged in a U.S. trade or business is foreign-source.[792]

<u>New Federal Law (IRC sections 864 and 1446)</u>

Under the provision, gain or loss from the sale or exchange of a partnership interest is effectively connected with a U.S. trade or business to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all of its assets at fair market value as of the date of the sale or exchange. The provision requires that any gain or loss from the hypothetical asset sale by the partnership be allocated to interests in the partnership in the same manner as nonseparately stated income and loss.

The provision also requires the transferee of a partnership interest to withhold 10 percent of the amount realized on the sale or exchange of a partnership interest unless the transferor certifies that the transferor is not a nonresident alien individual or foreign corporation. If the transferee fails to withhold the correct amount, the partnership is required to deduct and withhold from distributions to the transferee partner an amount equal to the amount the transferee failed to withhold.

The Secretary shall issue such regulations as the Secretary determines appropriate for the application of the provision, including in exchanges described in IRC sections 332, 351, 354, 355, 356, or 361.

Also, the provisions related to withholding are effective for sales and exchanges after December 31, 2017. Additionally, under regulatory authority to carry out withholding requirements of the provision, the Secretary may provide guidance permitting a broker, as agent of the transferee, to deduct and withhold the tax equal to 10 percent of the amount realized on the disposition of a partnership interest to which the provision applies. For example, such guidance may provide that if an interest in a publicly traded partnership is sold by a foreign partner through a broker, the broker may deduct and withhold the 10-percent tax on behalf of the transferee.

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[791] Revenue Ruling 91-32, 1991-1 C.B. 107.
[792] See Grecian Magnesite Mining v. Commissioner, 149 T.C. No. 3 (July 13, 2017).

Effective Dates

The portion of the provision treating gain or loss on sale of a partnership interest as effectively connected income is effective for sales, exchanges, and dispositions on or after November 27, 2017. The portion of the provision requiring withholding on sales or exchanges of partnership interests is effective for sales, exchanges, and dispositions after December 31, 2017.

California Law (R&TC sections 18666, 25110, and 25116)

In General

California does not generally conform to the "effectively connected income" rules of IRC section 864, but does conform as of the "specified date" of January 1, 2015,[793] to IRC section 864(b)(2)(A)(ii) that, notwithstanding R&TC sections 23040 and 25101, income derived from or attributable to sources within the state shall not include income loss, or gain from stocks and securities received by an alien corporation on the corporation's own account.[794] However, California does not generally conform to other provisions of IRC section 864 that exclude certain activities or income as "trade or business within the United States". As a result, California does not conform to the amended provisions of IRC section 864(c) relating to federal treatment of gain or loss of foreign persons from sale or exchange of interests in partnerships engaged in a trade or business within the United States.

California conforms to the withholding of tax by a partnership with foreign partners under IRC section 1446, as of the "specified date" of January 1, 2015, with modifications for the rates of tax, but does not conform to the federal requirement to withhold 10 percent of the amount realized on the sale or exchange of a partnership interest unless the transferor certifies that the transferor is not a nonresident alien individual or foreign corporation.

Water's-Edge Method

Certain corporations doing business within and outside California may elect to determine their business income under a water-edge's method. This water's-edge election generally allows the unitary business to exclude foreign corporations from the calculation of business income, but includes the entire income and apportionment factors of certain affiliated foreign corporations. In addition, a foreign corporation with U.S. source income and a controlled foreign corporation with Subpart F income may have income and apportionment factors includible in the water's-edge return.

Under R&TC section 25110 and the regulations promulgated thereunder, California conforms to the extent income is sourced to the United States. Thus, California is already conformed to the federal treatment of gain or loss of foreign persons from sale or exchange of interests in partnerships engaged in trade or business within the United States for water's-edge purposes.

[793] R&TC section 17024.5.
[794] R&TC section 23040.1.

Impact on California Revenue

Baseline.

Section	Section Title
13502	Modify Definition of Substantial Built-In Loss in the Case of Transfer of Partnership Interest

Background

In general, a partnership does not adjust the basis of partnership property following the transfer of a partnership interest unless either the partnership has made a one-time election under IRC section 754 to make basis adjustments, or the partnership has a substantial built-in loss immediately after the transfer.[795]

If an election is in effect, or if the partnership has a substantial built-in loss immediately after the transfer, adjustments are made with respect to the transferee partner. These adjustments are to account for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property and the transferee's basis in its partnership interest.[796] The adjustments are intended to adjust the basis of partnership property to approximate the result of a direct purchase of the property by the transferee partner.

Under the provision, a substantial built-in loss exists if the partnership's adjusted basis in its property exceeds by more than $250,000 the fair market value of the partnership property.[797]

Certain securitization partnerships and electing investment partnerships are not treated as having a substantial built-in loss in certain instances, and thus are not required to make basis adjustments to partnership property.[798] For electing investment partnerships, in lieu of the partnership basis adjustments, a partner-level loss limitation rule applies.[799]

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[795] IRC section 743(a).
[796] IRC section 743(b).
[797] IRC section 743(d).
[798] See IRC section 743(e) (alternative rules for electing investment partnerships) and IRC section 743(f) (exception for securitization partnerships).
[799] Unlike in the case of an electing investment partnership, the partner-level loss limitation rule does not apply for a securitization partnership.

New Federal Law (IRC section 743)

The provision modifies the definition of a substantial built-in loss for purposes of IRC section 743(d), affecting transfers of partnership interests. Under the provision, in addition to the present-law definition, a substantial built-in loss also exists if the transferee would be allocated a net loss in excess of $250,000 upon a hypothetical disposition by the partnership of all of the partnership's assets in a fully taxable transaction for cash equal to the assets' fair market value, immediately after the transfer of the partnership interest.

For example, a partnership of three taxable partners (partners A, B, and C) has not made an election pursuant to IRC section 754. The partnership has two assets, one of which, Asset X, has a built-in gain of $1 million, while the other asset, Asset Y, has a built-in loss of $900,000. Pursuant to the partnership agreement, any gain on sale or exchange of Asset X is specially allocated to partner A. The three partners share equally in all other partnership items, including in the built-in loss in Asset Y. In this case, each of partner B and partner C has a net built-in loss of $300,000 (one third of the loss attributable to asset Y) allocable to his partnership interest. Nevertheless, the partnership does not have an overall built-in loss, but a net built-in gain of $100,000 ($1 million minus $900,000). Partner C sells his partnership interest to another person, D, for $33,333. Under the provision, the test for a substantial built-in loss applies both at the partnership level and at the transferee partner level. If the partnership were to sell all its assets for cash at their fair market value immediately after the transfer to D, D would be allocated a loss of $300,000 (one third of the built-in loss of $900,000 in Asset Y). A substantial built-in loss exists under the partner-level test added by the provision, and the partnership adjusts the basis of its assets accordingly with respect to D.

Effective Dates

The provision applies to transfers of partnership interests after December 31, 2017.

California Law (R&TC section 17851)

California conforms, under the PITL, to federal laws that govern the taxation of partnerships as of the "specified date" of January 1, 2015[800] with modifications, but does not conform to the modification of the definition of substantial built-in loss in the case of the transfer of partnership interests.

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[800] R&TC section 17851 conforms to Subchapter K of Chapter 1 of Subtitle A of the IRC as of the "specified date" of January 1, 2015, under section 17024.5, except as otherwise provided.

Impact on California Revenue

Estimated Conformity Revenue Impact of Modify Definition of Substantial Built-In Loss in the Case of Transfer of Partnership Interest For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	- $1,100,000	$2,900,000	$4,500,000

Section | Section Title

13503 | Charitable Contributions and Foreign Taxes Taken into Account in Determining Limitation on Allowance of Partner's Share of Loss

Background

A partner's distributive share of partnership loss (including capital loss) is allowed only to the extent of the adjusted basis (before reduction by current year's losses) of the partner's interest in the partnership at the end of the partnership taxable year in which the loss occurred. Any disallowed loss is allowable as a deduction at the end of the first succeeding partnership taxable year, and subsequent taxable years, to the extent that the partner's adjusted basis for its partnership interest at the end of any such year exceeds zero (before reduction by the loss for the year).[801]

A partner's basis in its partnership interest is increased by its distributive share of income (including tax-exempt income). A partner's basis in its partnership interest is decreased (but not below zero) by distributions by the partnership and its distributive share of partnership losses and expenditures of the partnership not deductible in computing partnership taxable income and not properly chargeable to capital account.[802] In the case of a charitable contribution, a partner's basis is reduced by the partner's distributive share of the adjusted basis of the contributed property.[803]

A partnership computes its taxable income in the same manner as an individual with certain exceptions. The exceptions provide, in part, that the deductions for foreign taxes and charitable contributions are not allowed to the partnership.[804] Instead, a partner takes into account its

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[801] IRC section 704(d) and Treasury Regulation section 1.704-1(d)(1).
[802] IRC section 705(a).
[803] Revenue Ruling 96-11, 1996-1 C. B. 140.
[804] IRC section 703(a)(2)(B) and (C). In addition, IRC section 703(a)(2) provides that other deductions are not allowed to the partnership, notwithstanding that the partnership's taxable income is computed in the same manner as an

distributive share of the foreign taxes paid by the partnership and the charitable contributions made by the partnership for the taxable year.[805]

However, in applying the basis limitation on partner losses, Treasury regulations do not take into account the partner's share of partnership charitable contributions and foreign taxes paid or accrued.[806] The IRS has taken the position in a private letter ruling that the basis limitation on partner losses does not apply to limit the partner's deduction for its share of the partnership's charitable contributions.[807] While the regulations relating to the loss limitation do not mention the foreign tax credit, a taxpayer may choose the foreign tax credit in lieu of deducting foreign taxes.[808]

By contrast, under S corporation rules limiting the losses and deductions which may be taken into account by a shareholder of an S corporation to the shareholder's basis in stock and debt of the corporation, the shareholder's pro rata share of charitable contributions and foreign taxes are taken into account.[809] In the case of charitable contributions, a special rule is provided prorating the amount of appreciation not subject to the limitation in the case of charitable contributions of appreciated property by the S corporation.[810]

<u>New Federal Law (IRC section 704)</u>

The provision modifies the basis limitation on partner losses to provide that the limitation takes into account a partner's distributive share of partnership charitable contributions (as defined in IRC section 170(c)) and taxes (described in IRC section 901) paid or accrued to foreign countries and to possessions of the United States. Thus, the amount of the basis limitation on partner losses is decreased to reflect these items. In the case of a charitable contribution by the partnership, the amount of the basis limitation on partner losses is decreased by the partner's distributive share of the adjusted basis of the contributed property. In the case of a charitable contribution by the partnership of property whose fair market value exceeds its adjusted basis, a

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individual's taxable income, specifically: personal exemptions, net operating loss deductions, certain itemized deductions for individuals, or depletion.

805 IRC section 702.

806 The regulation provides that "[i]f the partner's distributive share of the aggregate of items of loss specified in IRC section 702(a)(1), (2), (3), (8) [now (7)], and (9) [now (8)] exceeds the basis of the partner's interest computed under the preceding sentence, the limitation on losses under IRC section 704(d) must be allocated to his distributive share of each such loss." The regulation does not refer to IRC section 702(a)(4) (charitable contributions) and 702(a)(6) (foreign taxes paid or accrued). Treasury Regulation section 1.704-1(d)(2).

807 Private Letter Ruling 8405084. And see William S. McKee, William F. Nelson and Robert L. Whitmire, *Federal Taxation of Partnerships and Partners*, WG&L, 4th Edition (2011), paragraph 11.05[1][b], pp. 11-214 (noting that the "failure to include charitable contributions in the § 704(d) limitation is an apparent technical flaw in the statute. Because of it, a zero-basis partner may reap the benefits of a partnership charitable contribution without an offsetting decrease in the basis of his interest, whereas a fellow partner who happens to have a positive basis may do so only at the cost of a basis decrease.").

808 IRC section 901.

809 IRC section 1366(d) and IRC section 1366(a)(1). Under a related rule, the shareholder's basis in his interest is decreased by the basis (rather than the fair market value) of appreciated property by reason of a charitable contribution of the property by the S corporation (IRC section 1367(a)(2)).

810 IRC section 1366(d)(4).

special rule provides that the basis limitation on partner losses does not apply to the extent of the partner's distributive share of the excess.

Effective Dates

The provision applies to partnership taxable years beginning after December 31, 2017.

California Law (R&TC section 17851)

California conforms, under the PITL, to federal laws that govern the taxation of partnerships as of the "specified date" of January 1, 2015,[811] with modifications, but does not conform to charitable contributions and foreign taxes being taken into account in determining limitation on allowance of partner's share of loss.

Impact on California Revenue

Estimated Conformity Revenue Impact of Charitable Contributions and Foreign Taxes Taken into Account in Determining Limitation on Allowance of Partner's Share of Loss For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	$6,300,000	$4,500,000	$4,500,000

Section	Section Title
13504	Repeal of Technical Termination of Partnerships

Background

A partnership is considered as terminated under specified circumstances.[812] Special rules apply in the case of the merger, consolidation, or division of a partnership.[813]

A partnership is treated as terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.[814]

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[811] R&TC section 17851 conforms to Subchapter K of Chapter 1 of Subtitle A of the IRC as of the "specified date" of January 1, 2015 under section 17024.5, except as otherwise provided.
[812] IRC section 708(b)(1).
[813] IRC section 708(b)(2). Mergers, consolidations, and divisions of partnerships take either an assets-over form or an assets-up form pursuant to Treasury Regulation section 1.708-1(c).
[814] IRC section 708(b)(1)(A).

A partnership is also treated as terminated if within any 12-month period, there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits.[815] This is sometimes referred to as a technical termination. Under regulations, the technical termination gives rise to a deemed contribution of all the partnership's assets and liabilities to a new partnership in exchange for an interest in the new partnership, followed by a deemed distribution of interests in the new partnership to the purchasing partners and the other remaining partners.[816]

The effect of a technical termination is not necessarily the end of the partnership's existence, but rather the termination of some tax attributes. Upon a technical termination, the partnership's taxable year closes, potentially resulting in short taxable years.[817] Partnership-level elections generally cease to apply following a technical termination.[818] A technical termination generally results in the restart of partnership depreciation recovery periods.

<u>New Federal Law (IRC section 708)</u>

The provision repeals the IRC section 708(b)(1)(B) rule providing for technical terminations of partnerships. The provision does not change the present-law rule of IRC section 708(b)(1)(A) that a partnership is considered as terminated if no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership.

<u>Effective Dates</u>

The provision applies to partnership taxable years beginning after December 31, 2017.

<u>California Law (R&TC section 17851)</u>

California conforms, under the PITL, to federal laws that govern the taxation of partnerships as of the "specified date" of January 1, 2015,[819] with modifications, but does not conform to the repeal of technical terminations of partnerships.

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[815] IRC section 708(b)(1)(B).
[816] Treasury Regulation section 1.708-1(b)(4).
[817] IRC section 706(c)(1); Treasury Regulation section 1.708-1(b)(3).
[818] Partnership level elections include, for example, the IRC section 754 election to adjust basis on a transfer or distribution, as well as other elections that determine the partnership's tax treatment of partnership items. A list of elections can be found at William S. McKee, William F. Nelson, and Robert L. Whitmire*, Federal Taxation of Partnerships and Partners*, 4th edition, para. 9.01[7], pp. 9-42 - 9-44.
[819] R&TC section 17851 conforms to Subchapter K of Chapter 1 of Subtitle A of the IRC as of the "specified date" of January 1, 2015, under section 17024.5, except as otherwise provided.

Impact on California Revenue

Estimated Conformity Revenue Impact of Repeal of Technical Termination of Partnerships For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	$12,000,000	$5,800,000	$5,300,000

Subpart B—Insurance Reform

Section	Section Title
13511	Net Operating Losses of Life Insurance Companies

Background

A net operating loss (NOL) generally means the amount by which a taxpayer's business deductions exceed its gross income. In general, an NOL may be carried back two years and carried over 20 years to offset taxable income in such years. NOLs offset taxable income in the order of the taxable years to which the NOL may be carried.[820]

For purposes of computing the AMT, a taxpayer's NOL deduction cannot reduce the taxpayer's alternative minimum taxable income (AMTI) by more than 90 percent of the AMTI.[821]

In the case of a life insurance company, a deduction is allowed in the taxable year for operations loss carryovers and carrybacks, in lieu of the deduction for net operation losses allowed to other corporations.[822] A life insurance company is permitted to treat a loss from operations (as defined under IRC section 810(c)) for any taxable year as an operations loss carryback to each of the three taxable years preceding the loss year and an operations loss carryover to each of the 15 taxable years following the loss year.[823]

New Federal Law (IRC section 805)

The provision repeals the operations loss deduction for life insurance companies and allows the NOL deduction under IRC section 172.

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[820] IRC section 172(b)(2).
[821] IRC section 56(d).
[822] IRC sections 810, 805(a)(5).
[823] IRC section 810(b)(1).

Effective Dates

The provision applies to losses arising in taxable years beginning after December 31, 2017.

California Law (Section 28 of Article XIII of the California Constitution)

Insurance companies are not subject to the income or franchise taxes that are administered by the Franchise Tax Board (FTB). Instead, insurance companies must be admitted to do business in California, and once admitted, they are subject to the gross premiums tax that is administered by the Board of Equalization (BOE).

Impact on California Revenue

Not applicable.

Section	Section Title
13512	Repeal of Small Life Insurance Company Deduction

Background

The small life insurance company deduction for any taxable year is 60 percent of the amount of the tentative life insurance company taxable income (LICTI) for such taxable year that does not exceed $3 million, reduced by 15 percent of the excess of tentative LICTI over $3 million. The maximum deduction that can be claimed by a small company is $1.8 million, and a company with a tentative LICTI of $15 million or more is not entitled to any small company deduction. A small life insurance company for this purpose is one with less than $500 million of assets.

New Federal Law (IRC section 806)

The provision repeals the small life insurance company deduction.

Effective Dates

The provision applies to taxable years beginning after December 31, 2017.

California Law (Section 28 of Article XIII of the California Constitution)

Insurance companies are not subject to the income or franchise taxes that are administered by the FTB. Instead, insurance companies must be admitted to do business in California, and once admitted, they are subject to the gross premiums tax that is administered by the BOE.

Impact on California Revenue

Not applicable.

Section	Section Title
13513	Adjustment for Change in Computing Reserves

Background

Change in Method of Accounting

In general, a taxpayer may change its method of accounting under IRC section 446 with the consent of the Secretary (or may be required to change its method of accounting by the Secretary). In such instances, a taxpayer generally is required to make an adjustment (a "section 481(a) adjustment") to prevent amounts from being duplicated in, or omitted from, the calculation of the taxpayer's income. Pursuant to IRS procedures, negative IRC section 481(a) adjustments generally are deducted from income in the year of the change whereas positive IRC section 481(a) adjustments generally are required to be included in income ratably over four taxable years.[824] However, IRC section 807(f) explicitly provides that changes in the basis for determining life insurance company reserves are to be taken into account ratably over 10 years.

10-Year Spread for Change in Computing Life Insurance Company Reserves

For Federal income tax purposes, a life insurance company includes in gross income any net decrease in reserves, and deducts a net increase in reserves.[825] Methods for determining reserves for tax purposes generally are based on reserves prescribed by the National Association of Insurance Commissioners for purposes of financial reporting under State regulatory rules.

Income or loss resulting from a change in the method of computing reserves is taken into account ratably over a 10-year period.[826] The rule for a change in basis in computing reserves applies only if there is a change in basis in computing the federally prescribed reserve (as distinguished from the net surrender value). Although life insurance tax reserves require the use of a Federally prescribed method, interest rate, and mortality or morbidity table, changes in other assumptions for computing statutory reserves (*e.g.*, when premiums are collected and claims are paid) may cause increases or decreases in a company's life insurance reserves that must be spread over a 10-year period. Changes in the net surrender value of a contract are not subject to the 10-year spread because, apart from its use as a minimum in determining the amount of life insurance tax reserves, the net surrender value is not a reserve but a current liability.

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[824] See, *e.g.*, Revenue Procedure 2015-13, 2015-5 I.R.B. 419, and Revenue Procedure 2017-30, 2017-18 I.R.B. 1131.
[825] IRC section 807.
[826] IRC section 807(f).

If for any taxable year the taxpayer is not a life insurance company, the balance of any adjustments to reserves is taken into account for the preceding taxable year.

New Federal Law (IRC section 807)

Income or loss resulting from a change in method of computing life insurance company reserves is taken into account consistent with IRS procedures, generally ratably over a four-year period, instead of over a 10-year period.

Effective Dates

The provision applies to taxable years beginning after December 31, 2017.

California Law (Section 28 of Article XIII of the California Constitution)

Insurance companies are not subject to the income or franchise taxes that are administered by the FTB. Instead, insurance companies must be admitted to do business in California, and once admitted, are subject to the gross premiums tax that is administered by the BOE.

Impact on California Revenue

Not applicable.

Section	Section Title
13514	Repeal of Special Rule for Distributions to Shareholders from Pre-1984 Policyholders Surplus Account

Background

Under the law in effect from 1959 through 1983, a life insurance company was subject to a three-phase taxable income computation under Federal tax law. Under the three-phase system, a company was taxed on the lesser of its gain from operations or its taxable investment income (Phase I) and, if its gain from operations exceeded its taxable investment income, 50 percent of such excess (Phase II). Federal income tax on the other 50 percent of the gain from operations was deferred, and was accounted for as part of a policyholder's surplus account and, subject to certain limitations, taxed only when distributed to shareholders or upon corporate dissolution (Phase III). To determine whether amounts had been distributed, a company maintained a shareholders surplus account, which generally included the company's previously taxed income that would be available for distribution to shareholders. Distributions to shareholders were treated as being first out of the shareholders surplus account, then out of the policyholders surplus account, and finally out of other accounts.

The Deficit Reduction Act of 1984[827] included provisions that, for 1984 and later years, eliminated further deferral of tax on amounts (described above) that previously would have been deferred under the three-phase system. Although for taxable years after 1983, life insurance companies may not enlarge their policyholders surplus account, the companies are not taxed on previously deferred amounts unless the amounts are treated as distributed to shareholders or subtracted from the policyholders surplus account.[828]

Any direct or indirect distribution to shareholders from an existing policyholders surplus account of a stock life insurance company is subject to tax at the corporate rate in the taxable year of the distribution. Present law (like prior law) provides that any distribution to shareholders is treated as made (1) first out of the shareholders surplus account, to the extent thereof, (2) then out of the policyholders surplus account, to the extent thereof, and (3) finally, out of other accounts.

For taxable years beginning after December 31, 2004, and before January 1, 2007, the application of the rules imposing income tax on distributions to shareholders from the policyholders surplus account of a life insurance company were suspended. Distributions in those years were treated as first made out of the policyholders surplus account, to the extent thereof, and then out of the shareholders surplus account, and lastly out of other accounts.

New Federal Law (IRC section 815)

The provision repeals IRC section 815, the rules imposing income tax on distributions to shareholders from the policyholders surplus account of a stock life insurance company.

In the case of any stock life insurance company with an existing policyholders surplus account (as defined in IRC section 815 before its repeal), tax is imposed on the balance of the account as of December 31, 2017. A life insurance company is required to pay tax on the balance of the account ratably over the first eight taxable years beginning after December 31, 2017. Specifically, the tax imposed on a life insurance company is the tax on the sum of life insurance company taxable income for the taxable year (but not less than zero) plus 1/8 of the balance of the existing policyholders surplus account as of December 31, 2017. Thus, life insurance company losses are not allowed to offset the amount of the policyholders surplus account balance subject to tax.

Effective Dates

The provision applies to taxable years beginning after December 31, 2017.

California Law (Section 28 of Article XIII of the California Constitution)

Insurance companies are not subject to the income or franchise taxes that are administered by the FTB. Instead, insurance companies must be admitted to do business in California, and once admitted, they are subject to the gross premiums tax that is administered by the BOE.

[827] Pub. L. No. 98-369.
[828] IRC section 815.

Impact on California Revenue

Not applicable.

Section	Section Title
13515	Modification of Proration Rules for Property and Casualty Insurance Companies

Background

The taxable income of a property and casualty insurance company is determined as the sum of its gross income from underwriting income and investment income (as well as gains and other income items), reduced by allowable deductions.

A proration rule applies to property and casualty insurance companies. In calculating the deductible amount of its reserve for losses incurred, a property and casualty insurance company must reduce the amount of losses incurred by 15 percent of (1) the insurer's tax-exempt interest, (2) the deductible portion of dividends received (with special rules for dividends from affiliates), and (3) the increase for the taxable year in the cash value of life insurance, endowment, or annuity contracts the company owns.[829] This proration rule reflects the fact that reserves are generally funded in part from tax-exempt interest, from deductible dividends, and from other untaxed amounts.

New Federal Law (IRC section 832)

The provision replaces the 15-percent reduction under present law with a reduction equal to 5.25 percent divided by the top corporate tax rate. For 2018 and thereafter, the corporate tax rate is 21 percent, and the percentage reduction is 25 percent under the proration rule for property and casualty insurance companies. The proration percentage will be automatically adjusted in the future if the top corporate tax rate is changed, so that the product of the proration percentage and the top corporate tax rate always equals 5.25 percent.

Effective Dates

The provision applies to taxable years beginning after December 31, 2017.

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[829] IRC section 832(b)(5).

California Law (Section 28 of Article XIII of the California Constitution)

Insurance companies are not subject to the income or franchise taxes that are administered by the FTB. Instead, insurance companies must be admitted to do business in California, and once admitted, are subject to the gross premiums tax that is administered by the BOE.

Impact on California Revenue

Not applicable.

Section	Section Title
13516	Repeal of Special Estimated Tax Payments

Background

Allowance of Additional Deduction and Establishment of Special Loss Discount Account

Present law allows an insurance company required to discount its reserves an additional deduction that is not to exceed the excess of (1) the amount of the undiscounted unpaid losses over (2) the amount of the related discounted unpaid losses, to the extent the amount was not deducted in a preceding taxable year.[830] The provision imposes the requirement that a special loss discount account be established and maintained, and that special estimated tax payments be made. Unused amounts of special estimated tax payments are treated as an IRC section 6655 estimated tax payment for the 16th year after the year for which the special estimated tax payment was made.

The total payments by a taxpayer, including IRC section 6655 estimated tax payments and other tax payments, together with special estimated tax payments made under this provision, are generally the same as the total tax payments that the taxpayer would make if the taxpayer did not elect to have this provision apply, except to the extent amounts can be refunded under the provision in the 16th year.

Calculation of Special Estimated Tax Payments Based on Tax Benefit Attributable to Deduction

More specifically, present law imposes a requirement that the taxpayer make special estimated tax payments in an amount equal to the tax benefit attributable to the additional deduction allowed under the provision. If amounts are included in gross income as a result of a reduction in the taxpayer's special loss discount account or the liquidation or termination of the taxpayer's insurance business, and an additional tax is due for any year as a result of the inclusion, then an

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[830] IRC section 847.

amount of the special estimated tax payments equal to such additional tax is applied against such additional tax. If there is an adjustment reducing the amount of additional tax against which the special estimated tax payment was applied, then in lieu of any credit or refund for the reduction, a special estimated tax payment is treated as made in an amount equal to the amount that would otherwise be allowable as a credit or refund.

The amount of the tax benefit attributable to the deduction is to be determined (under Treasury regulations (which have yet to be promulgated)) by taking into account tax benefits that would arise from the carryback of any net operating loss for the year as well as current year benefits. In addition, tax benefits for the current and carryback years are to take into account the benefit of filing a consolidated return with another insurance company without regard to the consolidation limitations imposed by IRC section 1503(c).

The taxpayer's estimated tax payments under IRC section 6655 are to be determined without regard to the additional deduction allowed under this provision and the special estimated tax payments. Legislative history[831] indicates that it is intended that the taxpayer may apply the amount of an overpayment of any IRC section 6655 estimated tax payments for the taxable year against the amount of the special estimated tax payment required under this provision. The special estimated tax payments under this provision are not treated as estimated tax payments for purposes of IRC section 6655 (e.g., for purposes of calculating penalties or interest on underpayments of estimated tax) when such special estimated tax payments are made.

Refundable Amount

To the extent that a special estimated tax payment is not used to offset additional tax due for any of the first 15 taxable years beginning after the year for which the payment was made, such special estimated tax payment is treated as an estimated tax payment made under IRC section 6655 for the 16th year after the year for which the special estimated tax payment was made. If the amount of such deemed IRC section 6655 payment, together with the taxpayer's other payments credited against tax liability for such 16th year, exceeds the tax liability for such year, then the excess (up to the amount of the deemed IRC section 6655 payment) may be refunded to the taxpayer to the same extent provided under present law with respect to overpayments of tax.

Regulatory Authority

In addition to the regulatory authority to adjust the amount of special estimated tax payments in the event of a change in the corporate tax rate, authority is provided to the Treasury to prescribe regulations necessary or appropriate to carry out the purposes of the provision.

Such regulations include those providing for the separate application of the provision with respect to each accident year. Separate application of the provision with respect to each accident year (i.e., applying a vintaging methodology) may be appropriate under regulations to determine the amount of tax liability for any taxable year against which special estimated tax payments are applied, and to determine the amount (if any) of special estimated tax payments remaining after the 15th year which may be available to be refunded to the taxpayer.

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[831] See H.R. Rep. No. 100-1104, Conference Report to accompany H.R. 4333, the Technical and Miscellaneous Revenue Act of 1988, October 21, 1988, p. 174.

Regulatory authority is also provided to make such adjustments in the application of the provision as may be necessary to take into account the corporate AMT.

Under this regulatory authority, rules similar to those applicable in the case of a change in the corporate tax rate are intended to apply to determine the amount of special estimated tax payments that may be applied against tax calculated at the corporate AMT rate. The special estimated tax payments are not treated as payments of regular tax for purposes of determining the taxpayer's AMT liability.

Regulations have yet to be promulgated under IRC section 847.

New Federal Law (IRC section 847)

The provision repeals IRC section 847. Thus, the election to apply IRC section 847, the additional deduction, special loss discount account, special estimated tax payment, and refundable amount rules of present law are eliminated.

The entire balance of an existing account is included in income of the taxpayer for the first taxable year beginning after 2017, and the entire amount of existing special estimated tax payments are applied against the amount of additional tax attributable to this inclusion. Any special estimated tax payments in excess of this amount are treated as estimated tax payments under IRC section 6655.

Effective Dates

The provision applies to taxable years beginning after December 31, 2017.

California Law (Section 28 of Article XIII of the California Constitution)

Insurance companies are not subject to the income or franchise taxes that are administered by the FTB. Instead, insurance companies must be admitted to do business in California, and once admitted, they are subject to the gross premiums tax that is administered by the BOE.

Impact on California Revenue

Not applicable.

Section	Section Title
13517	Computation of Life Insurance Tax Reserves

Background

In General

In determining life insurance company taxable income, a life insurance company includes in gross income any net decrease in reserves, and deducts a net increase in reserves.[832] Methods for determining reserves for tax purposes generally are based on reserves prescribed by the National Association of Insurance Commissioners for purposes of financial reporting under State regulatory rules.

In computing the net increase or net decrease in reserves, six items are taken into account. These are (1) life insurance reserves; (2) unearned premiums and unpaid losses included in total reserves; (3) amounts that are discounted at interest to satisfy obligations under insurance and annuity contracts that do not involve life, accident, or health contingencies when the computation is made; (4) dividend accumulations and other amounts held at interest in connection with insurance and annuity contracts; (5) premiums received in advance and liabilities for premium deposit funds; and (6) reasonable special contingency reserves under contracts of group term life insurance or group accident and health insurance that are held for retired lives, premium stabilization, or a combination of both.

Life insurance reserves for any contract are the greater of the net surrender value of the contract or the reserves determined under Federally prescribed rules, but may not exceed the statutory reserve with respect to the contract (for regulatory reporting). In computing the federally prescribed reserve for any type of contract, the taxpayer must use the tax reserve method applicable to the contract, an interest rate for discounting of reserves to take account of the time value of money, and the prevailing commissioners' standard tables for mortality or morbidity.

Interest Rate

The assumed interest rate to be used in computing the federally prescribed reserve is the greater of the applicable Federal interest rate or the prevailing State assumed interest rate. The applicable Federal interest rate is the annual rate determined by the Secretary under the discounting rules for property and casualty reserves for the calendar year in which the contract is issued. The prevailing State assumed interest rate is generally the highest assumed interest rate permitted to be used in at least 26 States in computing life insurance reserves for insurance or annuity contracts of that type as of the beginning of the calendar year in which the contract is issued. In determining the highest assumed rates permitted in at least 26 States, each State is treated as permitting the use of every rate below its highest rate.

[832] IRC section 807.

A one-time election is permitted (revocable only with the consent of the Secretary) to apply an updated applicable Federal interest rate every five years in calculating life insurance reserves. The election is provided to take into account the fluctuations in market rates of return that companies experience with respect to life insurance contracts of long duration. The use of the updated applicable Federal interest rate under the election does not cause the recalculation of life insurance reserves for any prior year. Under the election no change is made to the interest rate used in determining life insurance reserves if the updated applicable Federal interest rate is less than one-half of one percentage point different from the rate used by the company in calculating life insurance reserves during the preceding five years.

<u>New Federal Law (IRC section 807)</u>

The provision provides that for purposes of determining the deduction for increases in certain reserves of a life insurance company, the amount of the life insurance reserves for any contract (other than certain variable contracts) is the greater of (1) the net surrender value of the contract (if any), or (2) 92.81 percent of the amount determined using the tax reserve method otherwise applicable to the contract as of the date the reserve is determined. In the case of a variable contract, the amount of life insurance reserves for the contract is the sum of (1) the greater of (a) the net surrender value of the contract, or (b) the separate-account reserve amount under IRC section 817 for the contract, plus (2) 92.81 percent of the excess (if any) of the amount determined using the tax reserve method otherwise applicable to the contract as of the date the reserve is determined over the amount determined in (1). In no event shall the reserves exceed the amount which would be taken into account in determining statutory reserves. As under present law, no deduction for asset adequacy or deficiency reserves is allowed.

The amount of life insurance reserves may not exceed the annual statement reserves. A no-double-counting rule provides that no amount or item is taken into account more than once in determining any reserve under subchapter L of the IRC. For example, an amount taken into account in determining a loss reserve under IRC section 807 may not also be taken into account in determining a loss reserve under IRC section 832. Similarly, a loss reserve determined under the tax reserve method (whether the Commissioners Reserve Valuation Method, the Commissioner's Annuity Reserve Valuation Method, a principles-based reserve method, or another method developed in the future, that is prescribed for a type of contract by the National Association of Insurance Commissioners) may not again be taken into account in determining the portion of the reserve that is separately accounted for under IRC section 817 or be included also in determining the net surrender value of a contract.

The provision provides reserve rules for supplemental benefits and retains present-law rules regarding certain contracts issued by foreign branches of domestic life insurance companies. The provision requires the Secretary to provide for reporting (at such time and in such manner as the Secretary shall prescribe) with respect to the opening balance and closing balance or reserves and with respect to the method of computing reserves for purposes of determining income. For this purpose, the Secretary may require that a life insurance company (including an affiliated group filing a consolidated return that includes a life insurance company) is required to report each of the line item elements of each separate account by combining them with each such item from all other separate accounts and the general account, and to report the combined amounts on a line-by-line basis on the taxpayer's return. Similarly, the Secretary may in such guidance provide that reporting on a separate account by separate account basis is generally not permitted. Under existing regulatory authority, if the Secretary determines it is necessary in order to carry out and enforce this provision, the Secretary may require e-filing or comparable filing of the return on magnetic media or other machine readable form, and may require that the taxpayer provide its annual statement via a link, electronic copy, or other similar means.

Effective Dates

The provision applies to taxable years beginning after December 31, 2017. For the first taxable year beginning after December 31, 2017, the difference in the amount of the reserve with respect to any contract at the end of the preceding taxable year and the amount of such reserve determined as if the proposal had applied for that year is taken into account for each of the eight taxable years following that preceding year, one-eighth per year.

California Law (Section 28 of Article XIII of the California Constitution)

Insurance companies are not subject to the income or franchise taxes that are administered by the FTB. Instead, insurance companies must be admitted to do business in California, and once admitted, they are subject to the gross premiums tax that is administered by the BOE.

Impact on California Revenue

Not applicable.

Section	Section Title
13518	Modification of Rules for Life Insurance Proration for Purposes of Determining the Dividends Received Deduction

Background

Reduction of Reserve Deduction and Dividends Received Deduction to Reflect Untaxed Income

A life insurance company is subject to proration rules in calculating life insurance company taxable income.

The proration rules reduce the company's deductions, including reserve deductions and dividends received deductions, if the life insurance company has tax-exempt income, deductible dividends received, or other similar untaxed income items, because deductible reserve increases can be viewed as being funded proportionately out of taxable and tax-exempt income.

Under the proration rules, the net increase and net decrease in reserves are computed by reducing the ending balance of the reserve items by the policyholders' share of tax-exempt interest.[833]

Similarly, under the proration rules, a life insurance company is allowed a dividends received deduction for intercorporate dividends from nonaffiliates only in proportion to the company's share of such dividends,[834] but not for the policyholders' share. Fully deductible dividends from affiliates are excluded from the application of this proration formula, if such dividends are not themselves distributions from tax-exempt interest or from dividend income that would not be fully deductible if received directly by the taxpayer. In addition, the proration rule includes in prorated amounts the increase for the taxable year in policy cash values of life insurance policies and annuity and endowment contracts.

Company's Share and Policyholder's Share

The life insurance company proration rules provide that the company's share, for this purpose, means the percentage obtained by dividing the company's share of the net investment income for the taxable year by the net investment income for the taxable year.[835] Net investment income means 95 percent of gross investment income, in the case of assets held in segregated asset accounts under variable contracts, and 90 percent of gross investment income in other cases.[836]

Gross investment income includes specified items.[837] The specified items include interest (including tax-exempt interest), dividends, rents, royalties and other related specified items, short-term capital gains, and trade or business income. Gross investment income does not include gain (other than short-term capital gain to the extent it exceeds net long-term capital loss) that is, or is considered as, from the sale or exchange of a capital asset. Gross investment income also does not include the appreciation in the value of assets that is taken into account in computing the company's tax reserve deduction under IRC section 817.

The company's share of net investment income, for purposes of this calculation, is the net investment income for the taxable year, reduced by the sum of (a) the policy interest for the taxable year and (b) a portion of policyholder dividends.[838] Policy interest is defined to include required interest at the greater of the prevailing State assumed rate or the applicable Federal rate (plus some other interest items). Present law provides that in any case where neither the prevailing State assumed interest rate nor the applicable Federal rate is used, "another appropriate rate" is used for this calculation. No statutory definition of "another appropriate rate" is provided; the law is unclear as to what rate or rates are appropriate for this purpose.[839]

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[833] IRC sections 807(a)(2)(B) and (b)(1)(B).
[834] IRC sections 805(a)(4), 812.
[835] IRC section 812(a).
[836] IRC section 812(c).
[837] IRC section 812(d).
[838] IRC section 812(b)(1). This portion is defined as gross investment income's share of policyholder dividends.
[839] Legislative history of IRC section 812 mentions that the general concept that items of investment yield should be allocated between policyholders and the company was retained from prior law. H. Rep. 98-861, Conference Report to accompany H.R. 4170, the Deficit Reduction Act of 1984, 98th Cong., 2d Sess., 1065 (June 23, 1984). *This concept*

In 2007, the IRS issued Revenue Ruling 2007-54,[840] interpreting required interest under IRC section 812(b) to be calculated by multiplying the mean of a contract's beginning-of-year and end-of-year reserves by the greater of the applicable Federal interest rate or the prevailing State assumed interest rate, for purposes of determining separate account reserves for variable contracts. However, Revenue Ruling 2007-54 was suspended by Revenue Ruling 2007-61, in which the IRS and the Treasury Department stated that the issues would more appropriately be addressed by regulation.[841] No regulations have been issued to date.

General Account and Separate Accounts

A variable contract is generally a life insurance (or annuity) contract whose death benefit (or annuity payout) depends explicitly on the investment return and market value of underlying assets.[842] The investment risk is generally that of the policyholder, not the insurer. The assets underlying variable contracts are maintained in separate accounts held by life insurers. These separate accounts are distinct from the insurer's general account in which it maintains assets supporting products other than variable contracts.

Reserves

For Federal income tax purposes, a life insurance company includes in gross income any net decrease in reserves, and deducts a net increase in reserves.[843] Methods for determining reserves for tax purposes generally are based on reserves prescribed by the National Association of Insurance Commissioners for purposes of financial reporting under State regulatory rules.

For purposes of determining the amount of the tax reserves for variable contracts, however, a special rule eliminates gains and losses. Under this rule,[844] in determining reserves for variable contracts, realized and unrealized gains are subtracted, and realized and unrealized losses are added, whether or not the assets have been disposed. The basis of assets in the separate account is increased to reflect appreciation, and reduced to reflect depreciation in value, that are taken into account in computing reserves for such contracts.

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is referred to in Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, JCS-41-84, December 31, 1984, p. 622, stating, "[u]nder the Act, the formula used for purposes of determining the policyholders' share is based generally on the proration formula used under prior law in computing gain or loss from operations (*i.e.*, by reference to 'required interest')." This may imply that a reference to pre-1984-law regulations may be appropriate. See Revenue Ruling 2003-120, 2003-2 C.B. 1154, and Technical Advice Memoranda 20038008 and 200339049.

[840] 2007-38 I.R.B. 604.

[841] 2007-42 I.R.B. 799.

[842] IRC section 817(d) provides a more detailed definition of a variable contract.

[843] IRC section 807.

[844] IRC section 817.

Dividends Received Deduction

A corporate taxpayer may partially or fully deduct dividends received.[845] The percentage of the allowable dividends received deduction depends on the percentage of the stock of the distributing corporation that the recipient corporation owns.

Limitation on Dividends Received Deduction under IRC Section 246(c)(4)

The dividends received deduction is not allowed with respect to stock either (1) held for 45 days or less during a 91-day period beginning 45 days before the ex-dividend date, or (2) to the extent the taxpayer is under an obligation to make related payments with respect to positions in substantially similar or related property.[846] The taxpayer's holding period is reduced for periods during which its risk of loss is reduced.[847]

New Federal Law (IRC section 812)

The provision modifies the life insurance company proration rule for reducing dividends received deductions and reserve deductions with respect to untaxed income. For purposes of the life insurance proration rule of IRC section 805(a)(4), the company's share is 70 percent. The policyholder's share is 30 percent.

Effective Dates

The provision applies to taxable years beginning after December 31, 2017.

California Law (Section 28 of Article XIII of the California Constitution)

Insurance companies are not subject to the income or franchise taxes that are administered by the FTB. Instead, insurance companies must be admitted to do business in California, and once admitted, they are subject to the gross premiums tax that is administered by the BOE.

Impact on California Revenue

Not applicable.

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[845] IRC section 243 *et seq*. Conceptually, dividends received by a corporation are retained in corporate solution; these amounts are taxed when distributed to noncorporate shareholders.
[846] IRC section 246(c).
[847] IRC section 246(c)(4). For this purpose, the holding period is reduced for periods in which (1) the taxpayer has an obligation to sell or has shorted substantially similar stock; (2) the taxpayer has granted an option to buy substantially similar stock; or (3) under Treasury regulations, the taxpayer has diminished its risk of loss by holding other positions with respect to substantially similar or related property.

Section	Section Title
13519	Capitalization of Certain Policy Acquisition Expenses

Background

In the case of an insurance company, specified policy acquisition expenses for any taxable year are required to be capitalized, and generally are amortized over the 120-month period beginning with the first month in the second half of the taxable year.[848]

A special rule provides for 60-month amortization of the first $5 million of specified policy acquisition expenses with a phase-out. The phase-out reduces the amount amortized over 60 months by the excess of the insurance company's specified policy acquisition expenses for the taxable year over $10 million.

Specified policy acquisition expenses are determined as that portion of the insurance company's general deductions for the taxable year that does not exceed a specific percentage of the net premiums for the taxable year on each of three categories of insurance contracts. For annuity contracts the percentage is 1.75; for group life insurance contracts the percentage is 2.05; and for all other specified insurance contracts the percentage is 7.7.

With certain exceptions, a specified insurance contract is any life insurance, annuity, or noncancellable accident and health insurance contract or combination thereof. A group life insurance contract is any life insurance contract that covers a group of individuals defined by reference to employment relationship, membership in an organization, or similar factor, the premiums for which are determined on a group basis, and the proceeds of which are payable to (or for the benefit of) persons other than the employer of the insured, an organization to which the insured belongs, or other similar person.

New Federal Law (IRC section 848)

The provision extends the amortization period for specified policy acquisition expenses from a 120-month period to the 180-month period beginning with the first month in the second half of the taxable year. The provision does not change the special rule providing for 60-month amortization of the first $5 million of specified policy acquisition expenses (with phase-out). The provision provides that for annuity contracts, the percentage is 2.09 percent; for group life insurance contracts the percentage is 2.45 percent; and for all other specified insurance contracts the percentage is 9.20 percent.

Effective Dates

The provision applies to taxable years beginning after December 31, 2017. A transition rule provides that specified policy acquisition expenses first required to be capitalized in a taxable year beginning before January 1, 2018, will continue to be allowed as a deduction ratably over the 120-month period beginning with the first month in the second half of such taxable year.

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[848] IRC section 848.

California Law (Section 28 of Article XIII of the California Constitution)

Insurance companies are not subject to the income or franchise taxes that are administered by the FTB. Instead, insurance companies must be admitted to do business in California, and once admitted, they are subject to the gross premiums tax that is administered by the BOE.

Impact on California Revenue

Not applicable.

Section	Section Title
13520	Tax Reporting for Life Settlement Transactions

Background

Present law imposes a variety of information reporting requirements on participants in certain transactions. These requirements are intended to assist taxpayers in preparing their income tax returns and to help the IRS determine whether such returns are correct and complete. For example, every person engaged in a trade or business generally is required to file information returns for each calendar year for payments of $600 or more made in the course of the payor's trade or business.[849] Payments to corporations generally are excepted from this requirement. Certain payments subject to information reporting also are subject to backup withholding if the payee has not provided a valid taxpayer identification number (TIN).

Under present law, any person required to file a correct information return who fails to do so on or before the prescribed filing date is subject to a penalty that varies based on when, if at all, the correct information return is filed.

New Federal Law (New IRC section 6050Y)

The provision imposes reporting requirements in the case of the purchase of an existing life insurance contract in a reportable policy sale and imposes reporting requirements on the payor in the case of the payment of reportable death benefits. The provision sets forth rules for determining the basis of a life insurance or annuity contract. Lastly, the provision modifies the transfer for value rules in a transfer of an interest in a life insurance contract in a reportable policy sale.

[849] IRC section 6041(a).

Reporting Requirements for Acquisitions of Life Insurance Contracts

Reporting Upon Acquisition of Life Insurance Contract

The reporting requirement applies to every person who acquires a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale during the taxable year. A reportable policy sale means the acquisition of an interest in a life insurance contract, directly or indirectly, if the acquirer has no substantial family, business, or financial relationship with the insured (apart from the acquirer's interest in the life insurance contract). An indirect acquisition includes the acquisition of an interest in a partnership, trust, or other entity that holds an interest in the life insurance contract.

Under the reporting requirement, the buyer reports information about the purchase to the IRS, to the insurance company that issued the contract, and to the seller. The information reported by the buyer about the purchase is (1) the buyer's name, address, and TIN, (2) the name, address, and TIN of each recipient of payment in the reportable policy sale, (3) the date of the sale, (4) the name of the issuer, and (5) the amount of each payment. The statement the buyer provides to any issuer of a life insurance contract is not required to include the amount of the payment or payments for the purchase of the contract.

Reporting of Seller's Basis in the Life Insurance Contract

On receipt of a report described above, or on any notice of the transfer of a life insurance contract to a foreign person, the issuer is required to report to the IRS and to the seller (1) the name, address, and TIN of the seller or the transferor to a foreign person, (2) the basis of the contract (i.e., the investment in the contract within the meaning of IRC section 72(e)(6)), and (3) the policy number of the contract. Notice of the transfer of a life insurance contract to a foreign person is intended to include any sort of notice, including information provided for nontax purposes such as change of address notices for purposes of sending statements or for other purposes, or information relating to loans, premiums, or death benefits with respect to the contract.

Reporting with Respect to Reportable Death Benefits

When a reportable death benefit is paid under a life insurance contract, the payor insurance company is required to report information about the payment to the IRS and to the payee. Under this reporting requirement, the payor reports (1) the name, address and TIN of the person making the payment, (2) the name, address, and TIN of each recipient of a payment, (3) the date of each such payment, (4) the gross amount of the payment, and (5) the payor's estimate of the buyer's basis in the contract. A reportable death benefit means an amount paid by reason of the death of the insured under a life insurance contract that has been transferred in a reportable policy sale.

For purposes of these reporting requirements, a payment means the amount of cash and the fair market value of any consideration transferred in a reportable policy sale.

Effective Dates

Under the provision, the reporting requirement is effective for reportable policy sales occurring after December 31, 2017, and reportable death benefits paid after December 31, 2017.

California Law (R&TC section 18631)

California law provides, under the Administration of Franchise and Income Tax Law (AFITL)[850], that the FTB may require a copy of any information return required to be filed with the Secretary of the Treasury under IRC section 6050Y, relating to returns relating to certain life insurance contract transactions, at the time and in the form and manner as the FTB may, by forms and instructions, require.

Impact on California Revenue

Not applicable.

Section	Section Title
13521	Clarification of Tax Basis of Life Insurance Contracts

Background

An exclusion from Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured.[851]

Under rules known as the transfer for value rules, if a life insurance contract is sold or otherwise transferred for valuable consideration, the amount paid by reason of the death of the insured that

[850] R&TC section 18631(c)(25).
[851] IRC section 101(a)(1). In the case of certain accelerated death benefits and viatical settlements, special rules treat certain amounts as amounts paid by reason of the death of an insured (that is, generally, excludable from income). IRC section 101(g). The rules relating to accelerated death benefits provide that amounts treated as paid by reason of the death of the insured include any amount received under a life insurance contract on the life of an insured who is a terminally ill individual, or who is a chronically ill individual (provided certain requirements are met). For this purpose, a terminally ill individual is one who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in 24 months or less after the date of the certification. A chronically ill individual is one who has been certified by a licensed health care practitioner within the preceding 12-month period as meeting certain ability-related requirements. In the case of a viatical settlement, if any portion of the death benefit under a life insurance contract on the life of an insured who is terminally ill or chronically ill is sold to a viatical settlement provider, the amount paid for the sale or assignment of that portion is treated as an amount paid under the life insurance contract by reason of the death of the insured (that is, generally, excludable from income). For this purpose, a viatical settlement provider is a person regularly engaged in the trade or business of purchasing, or taking assignments of, life insurance contracts on the lives of terminally ill or chronically ill individuals (provided certain requirements are met).

is excludable generally is limited.[852] Under the limitation, the excludable amount may not exceed the sum of (1) the actual value of the consideration, and (2) the premiums or other amounts subsequently paid by the transferee of the contract. Thus, for example, if a person buys a life insurance contract, and the consideration he pays combined with his subsequent premium payments on the contract are less than the amount of the death benefit he later receives under the contract, then the difference is includible in the buyer's income.

Exceptions are provided to the limitation on the excludable amount. The limitation on the excludable amount does not apply if (1) the transferee's basis in the contract is determined in whole or in part by reference to the transferor's basis in the contract,[853] or (2) the transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.[854]

IRS guidance sets forth more details of the tax treatment of a life insurance policyholder who sells or surrenders the life insurance contract and the tax treatment of other sellers and of buyers of life insurance contracts. The guidance relates to the character of taxable amounts (ordinary or capital) and to the taxpayer's basis in the life insurance contract.

In Revenue Ruling 2009-13,[855] the IRS ruled that income recognized under IRC section 72(e) on surrender to the life insurance company of a life insurance contract with cash value is ordinary income. In the case of sale of a cash value life insurance contract, the IRS ruled that the insured's (seller's) basis is reduced by the cost of insurance, and the gain on sale of the contract is ordinary income to the extent of the amount that would be recognized as ordinary income if the contract were surrendered (the "inside buildup"), and any excess is long-term capital gain. Gain on the sale of a term life insurance contract (without cash surrender value) is long-term capital gain under the ruling.

In Revenue Ruling 2009-14,[856] the IRS ruled that under the transfer for value rules, a portion of the death benefit received by a buyer of a life insurance contract on the death of the insured is includible as ordinary income. The portion is the excess of the death benefit over the consideration and other amounts (e.g., premiums) paid for the contract. Upon sale of the contract by the purchaser of the contract, the gain is long-term capital gain, and in determining the gain, the basis of the contract is not reduced by the cost of insurance.

<u>New Federal Law (IRC section 1016)</u>

The provision provides that in determining the basis of a life insurance or annuity contract, no adjustment is made for mortality, expense, or other reasonable charges incurred under the contract (known as "cost of insurance"). This reverses the position of the IRS in Revenue Ruling

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[852] IRC section 101(a)(2).
[853] IRC section 101(a)(2)(A).
[854] IRC section 101(a)(2)(B).
[855] 2009-21 I.R.B. 1029.
[856] 2009-21 I.R.B. 1031.

2009-13 that on sale of a cash value life insurance contract, the insured's (seller's) basis is reduced by the cost of insurance.

Effective Dates

The provision is effective for transactions entered into after August 25, 2009.

California Law (R&TC sections 18031, 18036, and 18036.5)

California conforms, under the PITL, to adjustments to basis under IRC section 1016, as of the specified date of January 1, 2015,[857] but does not conform to the federal clarification of tax basis for life insurance contracts.

Impact on California Revenue

Estimated Conformity Revenue Impact of Clarification of Tax Basis of Life Insurance Contracts[858] For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	- $3,400,000	$1,000,000	$2,200,000

Section	Section Title
13522	Exception to Transfer for Valuable Consideration Rules

Background

An exclusion from Federal income tax is provided for amounts received under a life insurance contract paid by reason of the death of the insured.[859]

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[857] R&TC section 17024.5.
[858] Amounts include revenue estimates for Act sections 13521 and 13522 combined.
[859] IRC section 101(a)(1). In the case of certain accelerated death benefits and viatical settlements, special rules treat certain amounts as amounts paid by reason of the death of an insured (that is, generally, excludable from income). IRC section 101(g). The rules relating to accelerated death benefits provide that amounts treated as paid by reason of the death of the insured include any amount received under a life insurance contract on the life of an insured who is a terminally ill individual, or who is a chronically ill individual (provided certain requirements are met). For this purpose, a terminally ill individual is one who has been certified by a physician as having an illness or physical condition which can reasonably be expected to result in death in 24 months or less after the date of the certification. A chronically ill individual is one who has been certified by a licensed health care practitioner within the preceding 12-month period as meeting certain ability-related requirements. In the case of a viatical settlement, if any portion of the death benefit under a life insurance contract on the life of an insured who is terminally ill or chronically ill is sold to a viatical settlement provider, the amount paid for the sale or assignment of that portion is treated as an amount

Under rules known as the transfer for value rules, if a life insurance contract is sold or otherwise transferred for valuable consideration, the amount paid by reason of the death of the insured that is excludable generally is limited.[860] Under the limitation, the excludable amount may not exceed the sum of (1) the actual value of the consideration, and (2) the premiums or other amounts subsequently paid by the transferee of the contract. Thus, for example, if a person buys a life insurance contract, and the consideration paid combined with subsequent premium payments on the contract are less than the amount of the death benefit later received under the contract, then the difference is includable in the buyer's income.

Exceptions are provided to the limitation on the excludable amount. The limitation on the excludable amount does not apply if (1) the transferee's basis in the contract is determined in whole or in part by reference to the transferor's basis in the contract,[861] or (2) the transfer is to the insured, to a partner of the insured, to a partnership in which the insured is a partner, or to a corporation in which the insured is a shareholder or officer.[862]

IRS guidance sets forth details of the tax treatment of a life insurance policyholder who sells or surrenders the life insurance contract and the tax treatment of other sellers and of buyers of life insurance contracts. The guidance relates to the character of taxable amounts (ordinary or capital) and to the taxpayer's basis in the life insurance contract.

In Revenue Ruling 2009-13,[863] the IRS ruled that income recognized under IRC section 72(e) on surrender to the life insurance company of a life insurance contract with cash value is ordinary income. In the case of sale of a cash value life insurance contract, the IRS ruled that the insured's (seller's) basis is reduced by the cost of insurance, and the gain on sale of the contract is ordinary income to the extent of the amount that would be recognized as ordinary income if the contract were surrendered (the "inside buildup"), and any excess is long-term capital gain. Gain on the sale of a term life insurance contract (without cash surrender value) is long-term capital gain under the ruling.

In Revenue Ruling 2009-14,[864] the IRS ruled that under the transfer for value rules, a portion of the death benefit received by a buyer of a life insurance contract on the death of the insured is includable as ordinary income. The portion is the excess of the death benefit over the consideration and other amounts (e.g., premiums) paid for the contract. Upon sale of the contract by the purchaser of the contract, the gain is long-term capital gain, and in determining the gain, the basis of the contract is not reduced by the cost of insurance.

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paid under the life insurance contract by reason of the death of the insured (that is, generally, excludable from income). For this purpose, a viatical settlement provider is a person regularly engaged in the trade or business of purchasing, or taking assignments of, life insurance contracts on the lives of terminally ill or chronically ill individuals (provided certain requirements are met).

[860] IRC section 101(a)(2).
[861] IRC section 101(a)(2)(A).
[862] IRC section 101(a)(2)(B).
[863] 2009-21 I.R.B. 1029.
[864] 2009-21 I.R.B. 1031.

New Federal Law (IRC section 101)

The provision provides that the exceptions to the transfer for value rules are inapplicable in the case of a transfer of a life insurance contract, or any interest in a life insurance contract, in a reportable policy sale. Thus, some portion of the death benefit ultimately payable under such a contract may be includable in income.

Effective Dates

The provision is effective for transfers occurring after December 31, 2017.

California Law (R&TC sections 17131 and 17132.5)

California conforms, under the PITL, to the treatment of certain death benefits under IRC section 101, as of the "specified date" of January 1, 2015,[865] with modifications, but does not conform to the federal exception to transfer for valuable consideration rules for life insurance contracts.

Impact on California Revenue

Estimated Conformity Revenue Impact of Exception to Transfer for Valuable Consideration Rules For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
See above Section 13521	See above Section 13521	See above Section 13521	See above Section 13521

Section	Section Title
13523	Modification of Discounting Rules for Property and Casualty Insurance Companies

Background

A property and casualty insurance company generally is subject to tax on its taxable income.[866] The taxable income of a property and casualty insurance company is determined as the sum of its underwriting income and investment income (as well as gains and other income items), reduced by allowable deductions.[867] Among the items that are deductible in calculating underwriting income are additions to reserves for losses and expenses incurred.

[865] R&TC section 17024.5.
[866] See Part II.A.1 (Reduction in corporate tax rate).
[867] IRC section 831(a).

To take account of the time value of money, discounting of unpaid losses is required. All property and casualty loss reserves (unpaid losses and unpaid loss adjustment expenses) for each line of business (as shown on the annual statement) are required to be discounted for Federal income tax purposes.

The discounted reserves are calculated using a prescribed interest rate which is based on the applicable Federal mid-term rate ("mid-term AFR"). The discount rate is the average of the mid-term AFRs effective at the beginning of each month over the 60-month period preceding the calendar year for which the determination is made.

To determine the period over which the reserves are discounted, a prescribed loss payment pattern applies. The prescribed length of time is either the accident year and the following three calendar years, or the accident year and the following 10 calendar years, depending on the line of business. In the case of certain "long-tail" lines of business, the 10-year period is extended, but not by more than five additional years. Thus, present law limits the maximum duration of any loss payment pattern to the accident year and the following 15 years. The Treasury Department is directed to determine a loss payment pattern for each line of business by reference to the historical loss payment pattern for that line of business using aggregate experience reported on the annual statements of insurance companies, and is required to make this determination every five years, starting with 1987.

Under the discounting rules, an election is provided permitting a taxpayer to use its own (rather than an industry-wide) historical loss payment pattern with respect to all lines of business, provided that applicable requirements are met.

Treasury publishes discount factors for each line of business to be applied by taxpayers for discounting reserves.[868] The discount factors are published annually, based on (1) the interest rate applicable to the calendar year, and (2) the loss payment pattern for each line of business as determined every five years.

<u>New Federal Law (IRC section 846)</u>

The provision modifies the reserve discounting rules applicable to property and casualty insurance companies. In general, the provision modifies the prescribed interest rate, extends the periods applicable under the loss payment pattern, and repeals the election to use a taxpayer's historical loss payment pattern.

Interest Rate

The provision provides that the interest rate is an annual rate for any calendar year to be determined by Treasury based on the corporate bond yield curve (rather than the mid-term AFR as under present law). For this purpose, the corporate bond yield curve means, with respect to any month, a yield curve that reflects the average, for the preceding 60-month period, of monthly

[868] The most recent property and casualty reserve discount factors published by Treasury are in Revenue Procedure 2016-58, 2016-51 I.R.B. 839, and see Revenue Procedure 2012-44, 2012-49 I.R.B. 645.

yields on investment grade corporate bonds with varying maturities and that are in the top three quality levels available.[869]

Loss Payment Patterns

The provision extends the periods applicable for determining loss payment patterns. Under the provision, the maximum duration of the loss payment pattern is determined by the amount of losses remaining unpaid using aggregate industry experience for each line of business, rather than by a set number of years as under present law.

Like present law, the provision provides that Treasury determines a loss payment pattern for each line of business by reference to the historical loss payment pattern for that line of business using aggregate experience reported on the annual statements of insurance companies, and is required to make this determination every five years.

Under the provision, the present-law three-year and 10-year periods following the accident year are extended up to a maximum of 14 more years for the lines of business to which each period applies. For lines of business to which the three-year period applies, the amount of losses that would have been treated as paid in the third year after the accident year is treated as paid in that year and each subsequent year in an amount equal to the average of the amounts treated as paid in the first and second years (or, if less, the remaining amount). To the extent these unpaid losses have not been treated as paid before the 18th year after the accident year, they are treated as paid in that 18th year.

Similarly, for lines of business to which the 10-year period applies, the amount of losses that would have been treated as paid in the 10th year following the accident year is treated as paid in that year and each subsequent year in an amount equal to the average of the amounts treated as paid in the seventh, eighth, and ninth years (or if less, the remaining amount). To the extent these unpaid losses have not been treated as paid before the 25th year after the accident year, they are treated as paid in that 25th year.

The provision repeals the present-law rule providing that in the case of certain "long-tail" lines of business, the 10-year period is extended, but not by more than five additional years. The provision does not change the lines of business to which the three-year, and 10-year, periods, respectively, apply.

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[869] This rule adopts the definition found in IRC section 430(h)(2)(D)(i) of the term "corporate bond yield curve." IRC section 430, which relates to minimum funding standards for single-employer defined benefit pension plans, includes other rules for determining an "effective interest rate," such as segment rate rules. The term "effective interest rate" along with these other rules, including the segment rate rules, do not apply for purposes of property and casualty insurance reserve discounting.

Election to Use Own Historical Loss Payment Pattern

The provision repeals the present-law election permitting a taxpayer to use its own (rather than an aggregate industry-experience-based) historical loss payment pattern with respect to all lines of business.

Effective Dates

The provision generally applies to taxable years beginning after December 31, 2017. Under a transitional rule for the first taxable year beginning in 2018, the amount of unpaid losses and expenses unpaid (under IRC section 832(b)(5)(B) and (6)) and the unpaid losses (under IRC sections 807(c)(2) and 805(a)(1)) at the end of the preceding taxable year are determined as if the provision had applied to these items in such preceding taxable year, using the interest rate and loss payment patterns for accident years ending with calendar year 2018. Any adjustment is spread over eight taxable years, *i.e.*, is included in the taxpayer's gross income ratably in the first taxable year beginning in 2018 and the seven succeeding taxable years. For taxable years subsequent to the first taxable year beginning in 2018, the provision applies to such unpaid losses and expenses unpaid (*i.e.*, unpaid losses and expenses unpaid at the end of the taxable year preceding the first taxable year beginning in 2018) by using the interest rate and loss payment patterns applicable to accident years ending with calendar year 2018.

California Law (Section 28 of Article XIII of the California Constitution)

Insurance companies are not subject to the income or franchise taxes that are administered by the FTB. Instead, insurance companies must be admitted to do business in California, and once admitted, they are subject to the gross premiums tax that is administered by the BOE.

Impact on California Revenue

Not applicable.

Subpart C—Banks and Financial Instruments

Section	Section Title
13531	Limitation on Deduction for FDIC Premiums

Background

Corporations organized under the laws of any of the 50 States (and the District of Columbia) generally are subject to the U.S. corporate income tax on their worldwide taxable income. The taxable income of a C corporation[870] generally comprises gross income less allowable deductions. A taxpayer generally is allowed a deduction for ordinary and necessary expenses paid or incurred in carrying on any trade or business.[871]

Corporations that make a valid election pursuant to IRC section 1362 of subchapter S of the IRC, referred to as S corporations, generally are not subject to corporate-level income tax on its items of income and loss. Instead, an S corporation passes through to shareholders its items of income and loss. The shareholders separately take into account their shares of these items on their individual income tax returns.

Banks, Thrifts, and Credit Unions

In General

Financial institutions are subject to the same Federal income tax rules and rates as are applied to other corporations or entities, with specified exceptions.

C Corporation Banks and Thrifts

A bank is generally taxed for Federal income tax purposes as a C corporation. For this purpose a bank generally means a corporation, a substantial portion of whose business is receiving deposits and making loans and discounts, or exercising certain fiduciary powers.[872] A bank for this purpose generally includes domestic building and loan associations, mutual stock or savings banks, and certain cooperative banks that are commonly referred to as thrifts.[873]

S Corporation Banks

A bank is generally eligible to elect S corporation status under IRC section 1362, provided it meets the other requirements for making this election and it does not use the reserve method of accounting for bad debts as described in IRC section 585.[874]

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[870] Corporations subject to tax are commonly referred to as C corporations after subchapter C of the IRC, which sets forth corporate tax rules. Certain specialized entities that invest primarily in real estate related assets (real estate investment trusts) or in stock and securities (regulated investment companies) and that meet other requirements, generally including annual distribution of 90 percent of their income, are allowed to deduct their distributions to shareholders, thus generally paying little or no corporate-level tax despite otherwise being subject to subchapter C.

[871] IRC section 162(a). However, certain exceptions apply. No deduction is allowed for (1) any charitable contribution or gift that would be allowable as a deduction under IRC section 170 were it not for the percentage limitations, the dollar limitations, or the requirements as to the time of payment, set forth in such section; (2) any illegal bribe, illegal kickback, or other illegal payment; (3) certain lobbying and political expenditures; (4) any fine or similar penalty paid to a government for the violation of any law; (5) two-thirds of treble damage payments under the antitrust laws; (6) certain foreign advertising expenses; (7) certain amounts paid or incurred by a corporation in connection with the reacquisition of its stock or of the stock of any related person; or (8) certain applicable employee remuneration.

[872] IRC section 581. See also Treasury Regulation section 1.581-1(a).

[873] While the general principles for determining the taxable income of a corporation are applicable to a mutual savings bank, a building and loan association, and a cooperative bank, there are certain exceptions and special rules for such institutions. Treasury Regulation section 1.581-2(a).

[874] IRC section 1361(b)(2)(A).

Special Bad Debt Loss Rules for Small Banks

IRC section 166 provides a deduction for any debt that becomes worthless (wholly or partially) within a taxable year. The reserve method of accounting for bad debts, repealed in 1986[875] for most taxpayers, is allowed under IRC section 585 for any bank (as defined in IRC section 581) other than a large bank. For this purpose, a bank is a large bank if, for the taxable year (or for any preceding taxable year after 1986), the average adjusted basis of all its assets (or the assets of the controlled group of which it is a member) exceeds $500 million. Deductions for reserves are taken in lieu of a worthless debt deduction under IRC section 166. Accordingly, a small bank is able to take deductions for additions to a bad debt reserve. Additions to the reserve are determined under an experience method that generally looks to the ratio of (1) the total bad debts sustained during the taxable year and the five preceding taxable years to (2) the sum of the loans outstanding at the close of such taxable years.[876]

Credit Unions

Credit unions are exempt from Federal income taxation.[877] The exemption is based on their status as not-for-profit mutual or cooperative organizations (without capital stock) operated for the benefit of their members, who generally must share a common bond. The definition of common bond has been expanded to permit greater use of credit unions.[878] While significant differences between the rules under which credit unions and banks operate have existed in the past, most of those differences have disappeared over time.[879]

FDIC premiums

The Federal Deposit Insurance Corporation (FDIC) provides deposit insurance for banks and savings institutions. To maintain its status as an insured depository institution, a bank must pay semiannual assessments into the deposit insurance fund (DIF). Assessments for deposit insurance are treated as ordinary and necessary business expenses. These assessments, also known as premiums, are deductible once the all events test for the premium is satisfied.[880]

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[875] Tax Reform Act of 1986, Pub. L. No. 99-514.
[876] IRC section 585(b)(2).
[877] IRC section 501(c)(14)(A). For a discussion of the history of and reasons for Federal tax exemption, see United States Department of the Treasury, *Comparing Credit Unions with Other Depository Institutions,* Report 3070, January 15, 2001, available at https://www.treasury.gov/press-center/press-releases/Documents/report30702.doc.
[878] The Credit Union Membership Access Act, Pub. L. No. 105-219, allows multiple common bond credit unions. The legislation in part responds to *National Credit Union Administration v. First National Bank & Trust Co.,* 522 U.S. 479 (1998), which interpreted the permissible membership of tax-exempt credit unions narrowly.
[879] The Treasury Department has concluded that any remaining regulatory differences do not raise competitive equity concerns between credit unions and banks. United States Department of the Treasury, *Comparing Credit Unions with Other Depository Institutions,* Report 3070, January 15, 2001, p. 2, available at https://www.treasury.gov/press-center/press-releases/Documents/report30702.doc.
[880] Technical Advice Memorandum 199924060, March 5, 1999, and Revenue Ruling 80-230, 1980-2 C.B. 169, 1980.

New Federal Law (IRC section 162)

No deduction is allowed for the applicable percentage of any FDIC premium paid or incurred by the taxpayer. For taxpayers with total consolidated assets of $50 billion or more, the applicable percentage is 100 percent. Otherwise, the applicable percentage is the ratio of the excess of total consolidated assets over $10 billion to $40 billion. For example, for a taxpayer with total consolidated assets of $20 billion, no deduction is allowed for 25 percent of FDIC premiums. The provision does not apply to taxpayers with total consolidated assets (as of the close of the taxable year) that do not exceed $10 billion.

FDIC premium means any assessment imposed under section 7(b) of the Federal Deposit Insurance Act.[881] The term total consolidated assets has the meaning given such term under section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[882]

For purposes of determining a taxpayer's total consolidated assets, members of an expanded affiliated group are treated as a single taxpayer. An expanded affiliated group means an affiliated group as defined in IRC section 1504(a), determined by substituting "more than 50 percent" for "at least 80 percent" each place it appears and without regard to the exceptions from the definition of includible corporation for insurance companies and foreign corporations. A partnership or any other entity other than a corporation is treated as a member of an expanded affiliated group if such entity is controlled by members of such group.

Effective Dates

The provision applies to taxable years beginning after December 31, 2017.

California Law (R&TC sections 17201 and 24343)

California conforms, under the PITL and the CTL, to the allowance for trade or business expenses under IRC section 162, as of the "specified date" of January 1, 2015,[883] with modifications, but does not conform to the federal limitation on the deduction for FDIC premiums.

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[881] 12 U.S.C. section 1817(b).
[882] Pub. L. No. 111-203.
[883] R&TC section 17851 conforms to Subchapter K of Chapter 1 of Subtitle A of the IRC as of the "specified date" of January 1, 2015, under section 17024.5, except as otherwise provided.

Impact on California Revenue

Estimated Conformity Revenue Impact of Limitation on Deduction for FDIC Premiums For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	$47,000,000	$55,000,000	$50,000,000

Section	Section Title
13532	Repeal of Advance Refunding Bonds

Background

IRC section 103 generally provides that gross income does not include interest received on State or local bonds. State and local bonds are classified generally as either governmental bonds or private activity bonds. Governmental bonds are bonds the proceeds of which are primarily used to finance governmental facilities or the debt is repaid with governmental funds. Private activity bonds are bonds in which the State or local government serves as a conduit providing financing to nongovernmental persons (*e.g.*, private businesses or individuals).[884] Bonds issued to finance the activities of charitable organizations described in IRC section 501(c)(3) ("qualified 501(c)(3) bonds") are one type of private activity bond. The exclusion from income for interest on State and local bonds only applies if certain IRC requirements are met.

The exclusion for income for interest on State and local bonds applies to refunding bonds but there are limits on advance refunding bonds. A refunding bond is defined as any bond used to pay principal, interest, or redemption price on a prior bond issue (the refunded bond).

Different rules apply to current as opposed to advance refunding bonds. A current refunding occurs when the refunded bond is redeemed within 90 days of issuance of the refunding bonds. Conversely, a bond is classified as an advance refunding if it is issued more than 90 days before the redemption of the refunded bond.[885] Proceeds of advance refunding bonds are generally invested in an escrow account and held until a future date when the refunded bond may be redeemed.

Although there is no statutory limitation on the number of times that tax-exempt bonds may be currently refunded, the IRC limits advance refundings. Generally, governmental bonds and

[884] IRC section 141.
[885] IRC section 149(d)(5).

qualified 501(c)(3) bonds may be advance refunded one time.[886] Private activity bonds, other than qualified 501(c)(3) bonds, may not be advance refunded at all.[887] Furthermore, in the case of an advance refunding bond that results in interest savings (*e.g.*, a high interest rate to low interest rate refunding), the refunded bond must be redeemed on the first call date 90 days after the issuance of the refunding bond that results in debt service savings.[888]

New Federal Law (IRC section 149)

The provision repeals the exclusion from gross income for interest on a bond issued to advance refund another bond.

Effective Dates

The provision applies to advance refunding bonds issued after December 31, 2017.

California Law

California does not conform to IRC section 149, relating to the exclusion from gross income for advance refunding bonds, or the federal rules relating to exempting the interest earned on state or municipal bonds. In addition, the federal "private activity bond" rules have not been adopted by California.

California State and Municipal Bonds

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

Unlike federal law, the interest earned on bonds issued by other states and municipalities in other states is fully taxable to a resident of California. The California exemption from income taxation of interest on bonds of the State and its political subdivisions is contained in the California Constitution.[889] The R&TC further provides, by statute, that the federal "private activity bond" analysis shall not be made in determining whether interest on bonds issued by the State or a political subdivision thereof shall be exempt from California income tax. Thus, in California, if the use of the bond proceeds of a California state or local issue is for private business use or is secured by property used for a private business use, the interest on that bond is still treated for California income tax purposes as tax exempt, even though the interest on the bond may well be taxable for federal income tax purposes.

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[886] IRC section 149(d)(3). Bonds issued before 1986 and pursuant to certain transition rules contained in the Tax Reform Act of 1986 may be advance refunded more than one time in certain cases.
[887] IRC section 149(d)(2).
[888] IRC section 149(d)(3)(A)(iii) and (B); Treasury Regulation section 1.149(d)-1(f)(3). A "call" provision provides the issuer of a bond with the right to redeem the bond prior to the stated maturity.
[889] California Constitution, Article XIII, section 26, subdivision (b).

California Conduit Revenue Bonds

Conduit revenue bonds are issued by a governmental (state or municipal) entity for various purposes, including economic development, educational and health facilities construction, and multi-family housing. The funds obtained from the financing are loaned to a non-governmental borrower who builds and operates the project. The use by a private firm (via expenditure of the bond proceeds) of a governmental agency's authority to issue tax-exempt debt is premised on the fact that the project will provide public benefit. A conduit revenue bond is payable solely from the loan payments received from the non-governmental party (unless the bond is insured by a third party who guarantees payment in the event of a default by the private firm who has pledged the revenue source). The governmental issuer typically has no liability for debt service on the bonds, except for the administration of the bond.

Although the issuer has no actual liability on the bonds, their reputation and standing with respect to future debt financing may be negatively affected in the event of a default on the bonds. More importantly, should the bonds go into default, the governmental entity will likely be drawn into the settlement process. Most conduit revenue bonds are sold at negotiated sales with the interest rate and other terms of the bonds negotiated between the issuer, the non-governmental borrower, and an underwriter. The security for some of these transactions is sufficient to allow the underwriter to act as a pass-through for the bonds and in so doing act as a placement agent rather than an underwriter. Since the public agency's credit is not on the line, many issuers do not participate in any substantive fashion in the sale of the bonds. Rather, they may limit their role to reviewing the bond purchase contract and other legal and disclosure documents to ensure that they are adequately indemnified against liabilities and to accurately describe their role to investors as issuers and not as borrowers or guarantors of the debt.

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

California Treatment of Federal Bond Interest

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

California Franchise Tax Treatment

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

Impact on California Revenue

Not applicable.

Subpart D—S Corporations

Section	Section Title
13541	Expansion of Qualifying Beneficiaries of an Electing Small Business Trust

Background

An electing small business trust (ESBT) may be a shareholder of an S corporation.[890] Generally, the eligible beneficiaries of an ESBT include individuals, estates, and certain charitable organizations eligible to hold S corporation stock directly. A nonresident alien individual may not be a shareholder of an S corporation and may not be a potential current beneficiary of an ESBT.[891]

The portion of an ESBT which consists of the stock of an S corporation is treated as a separate trust and generally is taxed on its share of the S corporation's income at the highest rate of tax imposed on individual taxpayers. This income (whether or not distributed by the ESBT) is not taxed to the beneficiaries of the ESBT.

New Federal Law (IRC section 1361)

The provision allows a nonresident alien individual to be a potential current beneficiary of an ESBT.

Effective Dates

The provision takes effect on January 1, 2018.

California Law (R&TC sections 17087.5 and 23800)

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[890] IRC section 1361(c)(2)(A)(v).
[891] IRC section 1361(b)(1)(C) and (c)(2)(B)(v).

California conforms, under the PITL and the CTL, to the definition of S corporations under IRC section 1361, as of the specified date of January 1, 2015,[892] with modifications, but does not conform to the federal expansion of qualifying beneficiaries of an electing small business trust who are eligible to be a shareholder of an S corporation.

Impact on California Revenue

Estimated Conformity Revenue Impact of Expansion of Qualifying Beneficiaries of an Electing Small Business Trust[893] For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	- $1,700,000	- $900,000	- $900,000

Section	Section Title
13542	Charitable Contribution Deduction for Electing Small Business Trusts

Background

An ESBT may be a shareholder of an S corporation.[894] The portion of an ESBT that consists of the stock of an S corporation is treated as a separate trust and generally is taxed on its share of the S corporation's income at the highest rate of tax imposed on individual taxpayers. This income (whether or not distributed by the ESBT) is not taxed to the beneficiaries of the ESBT. In addition to nonseparately computed income or loss, an S corporation reports to its shareholders their pro rata share of certain separately stated items of income, loss, deduction, and credit.[895] For this purpose, charitable contributions (as defined in IRC section 170(c)) of an S corporation are separately stated and taken by the shareholder.

The treatment of a charitable contribution passed through by an S corporation depends on the shareholder. Because an ESBT is a trust, the deduction for charitable contributions applicable to trusts,[896] rather than the deduction applicable to individuals,[897] applies to the trust. Generally, a trust is allowed a charitable contribution deduction for amounts of gross income, without limitation, which pursuant to the terms of the governing instrument are paid for a charitable purpose. No carryover of excess contributions is allowed. An individual is allowed a charitable contribution deduction limited to certain percentages of AGI generally with a five-year carryforward

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[892] R&TC sections 17024.5, 23051.5, and RT&C section 23800.5.
[893] Amounts include revenue estimates for Act sections 13541 and 13542 combined.
[894] IRC section 1361(c)(2)(A)(v).
[895] IRC section 1366(a)(1).
[896] IRC section 642(c).
[897] IRC section 170.

of amounts in excess of this limitation.

New Federal Law (IRC section 641)

The provision specifies that a charitable contribution deduction of an ESBT is not determined by the rules generally applicable to trusts but rather by the rules applicable to individuals. Thus, the percentage limitations and carryforward provisions applicable to individuals apply to charitable contributions made by the portion of an ESBT holding S corporation stock.

Effective Dates

The provision applies to taxable years beginning after December 31, 2017.

California Law (R&TC section 17731 and 17731.5)

California conforms, under the PITL, to the imposition of tax on estates, trusts, beneficiaries, and decedents under IRC section 641, as of the specified date of January 1, 2015,[898] with modifications for the rates of tax and exemptions, but does not conform to the federal modifications to the charitable contribution deduction for electing small business trusts.

Impact on California Revenue

Estimated Conformity Revenue Impact of Charitable Contribution Deduction for Electing Small Business Trusts For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
See above Section 13541	See above Section 13541	See above Section 13541	See above Section 13541

Section	Section Title
13543	Modification of Treatment of S Corporation Conversions to C Corporations

Background

Changes in Accounting Method

Cash and Accrual Methods in General

Taxpayers using the cash method generally recognize items of income when actually or constructively received and items of expense when paid. The cash method is administratively easy and provides the taxpayer flexibility in the timing of income recognition. It is the method generally used by most individual taxpayers, including farm and nonfarm sole proprietorships.

[898] R&TC section 17024.5.

Taxpayers using an accrual method generally accrue items of income when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy.[899] Taxpayers using an accrual method of accounting generally may not deduct items of expense prior to when all events have occurred that fix the obligation to pay the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred.[900] Accrual methods of accounting generally result in a more accurate measure of economic income than does the cash method. The accrual method is often used by businesses for financial accounting purposes.

A C corporation, a partnership that has a C corporation as a partner, or a tax-exempt trust or corporation with unrelated business income generally may not use the cash method. Exceptions are made for farming businesses,[901] qualified personal service corporations,[902] and the aforementioned entities to the extent their average annual gross receipts do not exceed $5 million for all prior years (including the prior taxable years of any predecessor of the entity) (the "gross receipts test").[903] The cash method may not be used by any tax shelter.[904] In addition, the cash method generally may not be used if the purchase, production, or sale of merchandise is an income producing factor.[905] Such taxpayers generally are required to keep inventories and use an accrual method with respect to inventory items.[906]

[899] See, *e.g.*, IRC section 451.
[900] See, *e.g.*, IRC section 461.
[901] A farming business is defined as a trade or business of farming, including operating a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts, or other crops, timber, or ornamental trees. IRC section 448(d)(1).
[902]A qualified personal service corporation is a corporation (1) substantially all of whose activities involve the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting, and (2) substantially all of the stock of which is owned by current or former employees performing such services, their estates, or heirs. IRC section 448(d)(2).
[903] The gross receipts test is modified to apply to taxpayers with annual average gross receipts that do not exceed $25 million for the three prior taxable-year period as part of this bill. See IRC section 3202 of the bill (Small business accounting method reform and simplification).
[904] IRC sections 448(a)(3) and (d)(3) and 461(i)(3) and (4). For this purpose, a tax shelter includes: (1) any enterprise (other than a C corporation) if at any time interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having the authority to regulate the offering of securities for sale; (2) any syndicate (within the meaning of IRC section 1256(e)(3)(B)); or (3) any tax shelter as defined in IRC section 6662(d)(2)(C)(ii). In the case of a farming trade or business, a tax shelter includes any tax shelter as defined in IRC section 6662(d)(2)(C)(ii) or any partnership or any other enterprise other than a corporation which is not an S corporation engaged in the trade or business of farming, (1) if at any time interests in such partnership or enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having authority to regulate the offering of securities for sale or (2) if more than 35 percent of the losses during any period are allocable to limited partners or limited entrepreneurs.
[905] Treasury Regulation sections 1.446-1(c)(2) and 1.471-1.
[906] IRC section 471 and Treasury Regulation sections 1.446-1(c)(2) and 1.471-1. However, an exemption is provided from the requirement to use inventories for taxpayers that meet the $25 million gross receipts test. Accordingly, under the bill, such taxpayers are thus also eligible to use the cash method.

Procedures for Changing a Method of Accounting

A taxpayer filing its first return may adopt any permissible method of accounting in computing taxable income for such year.[907] Except as otherwise provided, IRC section 446(e) requires taxpayers to secure consent of the Secretary before changing a method of accounting. The regulations under this section provide rules for determining: (1) what a method of accounting is, (2) how an adoption of a method of accounting occurs, and (3) how a change in method of accounting is effectuated.[908]

IRC section 481 prescribes the rules to be followed in computing taxable income in cases where the taxable income of the taxpayer is computed under a different method than the prior year (*e.g.*, when changing from the cash method to an accrual method). In computing taxable income for the year of change, the taxpayer must take into account those adjustments which are determined to be necessary solely by reason of such change in order to prevent items of income or expense from being duplicated or omitted.[909] The year of change is the taxable year for which the taxable income of the taxpayer is computed under a different method than the prior year.[910] Congress has provided the Secretary with the authority to prescribe the timing and manner in which such adjustments are taken into account in computing taxable income.[911] Net adjustments that decrease taxable income generally are taken into account entirely in the year of change, and net adjustments that increase taxable income generally are taken into account ratably during the four-taxable-year period beginning with the year of change.[912]

Post-Termination Distributions

Under present law, in the case of an S corporation that converts to a C corporation, distributions of cash by the C corporation to its shareholders during the post-termination transition period (to the extent of the amount in the accumulated adjustment account) are tax-free to the shareholders and reduce the adjusted basis of the stock.[913] The post-termination transition period is generally the one-year period after the S corporation election terminates.[914]

<u>New Federal Law (IRC section 481 and 1371)</u>

Under the provision, any IRC section 481(a) adjustment of an eligible terminated S corporation attributable to the revocation of its S corporation election (*i.e.*, a change from the cash method to

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[907] Treasury Regulation sections 1.446-1(e)(1).
[908] Treasury Regulation sections 1.446-1(e).
[909] IRC section 481(a)(2) and Treasury Regulation sections 1.481-1(a)(1).
[910] Treasury Regulation sections 1.481-1(a)(1).
[911] IRC section 481(c). While Treasury regulations generally provide that the entire adjustments required by IRC section 481(a) are taken into account entirely in the year of change, the Secretary has provided the Commissioner with the authority to provide additional guidance regarding the taxable year or years in which the adjustments are taken into account. See Treasury Regulation sections 1.481-1(c)(2).
[912] See Section 7.03 of Revenue Procedure 2015-13, 2015-5 I.R.B 419.
[913] IRC section 1371(e)(1).
[914] IRC section 1377(b).

an accrual method) is taken into account ratably during the six-taxable-year period beginning with the year of change.[915] An eligible terminated S corporation is any C corporation which (1) is an S corporation the day before the enactment of this bill, (2) during the two-year period beginning on the date of such enactment revokes its S corporation election under IRC section 1362(a), and (3) all of the owners of which on the date the S corporation election is revoked are the same owners (and in identical proportions) as the owners on the date of such enactment.

Under the provision, in the case of a distribution of money by an eligible terminated S corporation, the accumulated adjustments account shall be allocated to such distribution, and the distribution shall be chargeable to accumulated earnings and profits, in the same ratio as the amount of the accumulated adjustments account bears to the amount the accumulated earnings and profits.

Effective Dates

The provision is effective upon enactment.

California Law (R&TC sections 17087.5, 17551, 23806, 24667, 24710, and 24721)

Change in Method of Accounting

California conforms, under the PITL and the CTL, to adjustments required by changes in the method of accounting under IRC section 481, as of the specified date of January 1, 2015,[916] with modifications,[917] but does not conform to the federal modifications to the change in method of accounting treatment of S corporation conversions to C corporations.

Coordination with Subchapter C

California conforms, under the PITL and the CTL, to the application of subchapter C rules under IRC section 1371, as of the specified date of January 1, 2015,[918] with modifications[919], but does not conform to the federal changes to the application of Subchapter C rules to S corporations.

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[915] Expands the universe of partnerships and C corporations eligible to use the cash method to include partnerships or C corporations with annual average gross receipts that do not exceed $25 million for the three prior taxable-year period. Accordingly, an eligible terminated S corporation with annual average gross receipts that do not exceed $25 million that used the cash method prior to revoking its S corporation election may be eligible to remain on the cash method as a C corporation.
[916] R&TC section 17024.5.
[917] R&TC section 24667 and 24710.
[918] R&TC section 17024.5.
[919] R&TC section 23806. This section requires that any election by an S corporation or its shareholders under IRC section 338, relating to certain stock purchases treated as asset acquisitions, for federal purposes shall be treated as an election for California and no separate election is allowed under R&TC paragraph (3) of subdivision (e) of sections 17024.5 and 23051.5.

Impact on California Revenue

Estimated Conformity Revenue Impact of Modification of Treatment of S Corporation Conversions to C Corporations For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	- $25,000,000	- $21,000,000	- $20,000,000

Part VII—Employment
Subpart A—Compensation

Section	Section Title
13601	Modification of Limitation on Excessive Employee Remuneration

Background

In General

An employer generally may deduct reasonable compensation for personal services as an ordinary and necessary business expense. IRC section 162(m) provides an explicit limitation on the deductibility of compensation expenses in the case of publicly traded corporate employers. The otherwise allowable deduction for compensation with respect to a covered employee of a publicly held corporation is limited to no more than $1 million per year.[920] The deduction limitation applies when the deduction attributable to the compensation would otherwise be taken.

Covered Employees

IRC section 162(m) defines a covered employee as (1) the chief executive officer of the corporation (or an individual acting in such capacity) as of the close of the taxable year and (2) any employee whose total compensation is required to be reported to shareholders under the Securities Exchange Act of 1934 (Exchange Act) by reason of being among the corporation's four most highly compensated officers for the taxable year (other than the chief executive officer).[921] Treasury regulations under IRC section 162(m) provide that whether an employee is the chief executive officer or among the four most highly compensated officers should be determined pursuant to the executive compensation disclosure rules promulgated under the Exchange Act.

[920] IRC section 162(m). This deduction limitation applies for purposes of the regular income tax and the AMT.
[921] IRC section 162(m)(3).

In 2006, the Securities and Exchange Commission amended certain rules relating to executive compensation, including which officers' compensation must be disclosed under the Exchange Act. Under the new rules, such officers are (1) the principal executive officer (or an individual acting in such capacity), (2) the principal financial officer (or an individual acting in such capacity), and (3) the three most highly compensated officers, other than the principal executive officer or principal financial officer.

In response to the Securities and Exchange Commission's new disclosure rules, the IRS issued updated guidance on identifying which employees are covered by IRC section 162(m).[922] The new guidance provides that "covered employee" means any employee who is (1) as of the close of the taxable year, the principal executive officer (or an individual acting in such capacity) defined in reference to the Exchange Act, or (2) among the three most highly compensated officers[923] for the taxable year (other than the principal executive officer or principal financial officer), again defined by reference to the Exchange Act. Thus, under current guidance, only four employees are covered under IRC section 162(m) for any taxable year. Under Treasury regulations, the requirement that the individual meet the criteria as of the last day of the taxable year applies to both the principal executive officer and the three highest compensated officers.[924]

Definition of Publicly Held Corporation

For purposes of the deduction disallowance of IRC section 162(m), a publicly held corporation means any corporation issuing any class of common equity securities required to be registered under section 12 of the Securities Exchange Act of 1934.[925] All U.S. publicly traded companies are subject to this registration requirement, including their foreign affiliates. A foreign company publicly traded through American depository receipts (ADRs) is also subject to this registration requirement if more than 50 percent of the issuer's outstanding voting securities are held, directly or indirectly, by residents of the United States and either (i) the majority of the executive officers or directors are United States citizens or residents, (ii) more than 50 percent of the assets of the issuer are located in the United States, or (iii) the business of the issuer is administered principally in the United States. Other foreign companies are not subject to the registration requirement.

Remuneration Subject to the Deduction Limitation

In General

Unless specifically excluded, the deduction limitation applies to all remuneration for services, including cash and the cash value of all remuneration (including benefits) paid in a medium other than cash. If an individual is a covered employee for a taxable year, the deduction limitation applies to all compensation not explicitly excluded from the deduction limitation, regardless of whether the compensation is for services as a covered employee and regardless of when the

[922] Notice 2007-49, 2007-25 I.R.B. 1429.
[923] By reason of being among the officers whose total compensation is required to be reported to shareholders under the Securities Exchange Act of 1934.
[924] Treasury Regulation sections 1.162-27(c)(2).
[925] IRC section 162(m)(2).

compensation was earned. The $1 million cap is reduced by excess parachute payments (as defined in IRC section 280G) that are not deductible by the corporation.[926]

Certain types of compensation are not subject to the deduction limit and are not taken into account in determining whether other compensation exceeds $1 million. The following types of compensation are not taken into account: (1) remuneration payable on a commission basis:[927] (2) remuneration payable solely on account of the attainment of one or more performance goals if certain outside director and shareholder approval requirements are met ("performance-based compensation");[928] (3) payments to a tax-favored retirement plan (including salary reduction contributions); (4) amounts that are excludable from the executive's gross income (such as employer-provided health benefits and miscellaneous fringe benefits);[929] and (5) any remuneration payable under a written binding contract which was in effect on February 17, 1993. In addition, remuneration does not include compensation for which a deduction is allowable after a covered employee ceases to be a covered employee. Thus, the deduction limitation often does not apply to deferred compensation that is otherwise subject to the deduction limitation (*e.g.*, is not performance-based compensation) because the payment of compensation is deferred until after termination of employment.

Performance-Based Compensation

Compensation qualifies for the exception for performance-based compensation only if (1) it is paid solely on account of the attainment of one or more performance goals, (2) the performance goals are established by a compensation committee consisting solely of two or more outside directors,[930] (3) the material terms under which the compensation is to be paid, including the performance goals, are disclosed to and approved by the shareholders in a separate majority-approved vote prior to payment, and (4) prior to payment, the compensation committee certifies that the performance goals and any other material terms were in fact satisfied.

Compensation (other than stock options or other stock appreciation rights (SARs)) is not treated as paid solely on account of the attainment of one or more performance goals unless the compensation is paid to the particular executive pursuant to a pre-established objective performance formula or standard that precludes discretion. A stock option or SAR with an exercise price not less than the fair market value, on the date the option or SAR is granted, of the stock subject to the option or SAR, generally is treated as meeting the exception for performance-based compensation, provided that the requirements for outside director and shareholder approval are met (without the need for certification that the performance standards have been

[926] IRC section 162(m)(4)(F).
[927] IRC section 162(m)(4)(B).
[928] IRC section 162(m)(4)(C).
[929] IRC sections 105, 106, and 132.
[930] A director is considered an outside director if he or she is not a current employee of the corporation (or related entities), is not a former employee of the corporation (or related entities) who is receiving compensation for prior services (other than benefits under a qualified retirement plan), was not an officer of the corporation (or related entities) at any time, and is not currently receiving compensation for personal services in any capacity (*e.g.*, for services as a consultant) other than as a director.

met). This is the case because the amount of compensation attributable to the options or SARs received by the executive is based solely on an increase in the corporation's stock price.

Stock-based compensation is not treated as performance-based if it depends on factors other than corporate performance.

New Federal Law (IRC section 162)

Definition of Covered Employee

The provision revises the definition of covered employee to include both the principal executive officer and the principal financial officer. Further, an individual is a covered employee if the individual holds one of these positions at any time during the taxable year. The provision also defines as a covered employee the three (rather than four) most highly compensated officers for the taxable year (other than the principal executive officer or principal financial officer) who are required to be reported on the company's proxy statement (*i.e.*, the statement required pursuant to executive compensation disclosure rules promulgated under the Exchange Act) for the taxable year (or who would be required to be reported on such a statement for a company not required to make such a report to shareholders). This includes such officers of a corporation not required to file a proxy statement but which otherwise falls within the revised definition of a publicly held corporation, as well as such officers of a publicly traded corporation that would otherwise have been required to file a proxy statement for the year (for example, but for the fact that the corporation delisted its securities or underwent a transaction that resulted in the nonapplication of the proxy statement requirement).

In addition, if an individual is a covered employee with respect to a corporation for a taxable year beginning after December 31, 2016, the individual remains a covered employee for all future years. Thus, an individual remains a covered employee with respect to compensation otherwise deductible for subsequent years, including for years during which the individual is no longer employed by the corporation and years after the individual has died. Compensation does not fail to be compensation with respect to a covered employee and thus subject to the deduction limit for a taxable year merely because the compensation is includible in the income of, or paid to, another individual, such as compensation paid to a beneficiary after the employee's death, or to a former spouse pursuant to a domestic relations order.

Definition of Publicly Held Corporation

The provision extends the applicability of IRC section 162(m) to include all domestic publicly traded corporations and all foreign companies publicly traded through ADRs. The proposed definition may include certain additional corporations that are not publicly traded, such as large private C or S corporations.

Performance-Based Compensation and Commissions Exceptions

The provision eliminates the exceptions for commissions and performance-based compensation from the definition of compensation subject to the deduction limit. Thus, such compensation is taken into account in determining the amount of compensation with respect to a covered employee for a taxable year that exceeds $1 million and is thus not deductible under IRC section 162.

Effective Dates

The provision applies to taxable years beginning after December 31, 2017. A transition rule applies to remuneration which is provided pursuant to a written binding contract which was in effect on November 2, 2017, and which was not modified in any material respect on or after such date.

California Law (R&TC sections 17201 and 24343)

California conforms, under the PITL and the CTL, to the federal treatment of certain excessive employee remuneration under IRC section 162 as of the "specified date" of January 1, 2015,[931] but does not conform to the federal modifications to the limitation on excessive employee remuneration.

Impact on California Revenue

Estimated Conformity Revenue Impact of Modification of Limitation on Excessive Employee Remuneration For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	$24,000,000	$35,000,000	$34,000,000

Section	Section Title
13602	Excise Tax on Excess Tax-Exempt Organization Executive Compensation

Background

Taxable employers and other service recipients generally may deduct reasonable compensation expenses.[932] However, in some cases, compensation in excess of specific levels is not deductible.

A publicly held corporation generally cannot deduct more than $1 million of compensation (that is not compensation otherwise excepted from this limit) in a taxable year for each "covered

[931] R&TC section 17024.5.
[932] IRC section 162(a)(1).

employee."[933] For this purpose, a covered employee is the corporation's principal executive officer (or an individual acting in such capacity) defined in reference to the Exchange Act as of the close of the taxable year, or any employee whose total compensation is required to be reported to shareholders under the Exchange Act by reason of being among the corporation's three most highly compensated officers for the taxable year (other than the principal executive officer or principal financial officer).[934]

Unless an exception applies, generally a corporation cannot deduct that portion of the aggregate present value of a "parachute payment" which equals or exceeds three times the "base amount" of certain service providers. The nondeductible excess is an "excess parachute payment."[935] A parachute payment is generally a payment of compensation that is contingent on a change in corporate ownership or control made to certain officers, shareholders, and highly compensated individuals.[936] An individual's base amount is the average annualized compensation includible in the individual's gross income for the five taxable years ending before the date on which the change in ownership or control occurs.[937] Certain amounts are not considered parachute payments, including payments under a qualified retirement plan, a simplified employee pension plan, or a simple retirement account.[938]

These deduction limits generally do not affect a tax-exempt organization.

<u>New Federal Law (IRC section 4960)</u>

Under the provision, an excise tax will be imposed on covered employees of applicable tax-exempt organizations whose remuneration exceeds $1 million, or who receive excess parachute payments.

Specifically, a tax, equal to 21 percent, will be imposed on (1) remuneration (excluding any excess parachute payment) paid in any taxable year by an applicable tax-exempt organization to a covered employee that exceeds $1 million, plus (2) any excess parachute payment paid by an applicable tax-exempt organization to any covered employee.

Remuneration is treated as paid when there is not a substantial risk of forfeiture[939] of the rights to that remuneration. The tax imposed can apply to the value of remuneration that is vested (and any increases in that value or vested remuneration), even if it is not yet received. The applicable tax-exempt organization employer will be liable for any excise tax imposed on excess remuneration or excess parachute payment.

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[933] IRC section 162(m)(1). Under IRC section 162(m)(6), limits apply to deductions for compensation of individuals performing services for certain health insurance providers.
[934] Notice 2007-49, 2007-2 I.R.B. 1429.
[935] IRC section 280G(a) and (b)(1).
[936] IRC section 280G(b)(2) and (c).
[937] IRC section 280G(b)(3).
[938] IRC sections 401(a), 403(a), 408(k), and 408(p).
[939] IRC section 457(f)(3)(B).

Remuneration That Exceeds $1 Million

For purposes of this excise tax, an applicable tax-exempt organization is any organization which, for the tax year, is:

Exempt from tax under IRC section 501(a),
A farmer's cooperative organization under IRC section 521(b)(1),
Has income excluded from tax from states, municipalities, etc.,[940] or
A political organization.[941]

For purposes of this excise tax, remuneration is considered to be wages (as defined under IRC section 3401(a)), but not including any designated Roth contribution. Remuneration also includes amounts required to be included in gross income under IRC section 457(f), relating to ineligible deferred compensation plans.

Remuneration does not include the portion of any remuneration paid to a licensed medical professional (which includes veterinarians) for medical or veterinary services performed by that professional. However, remuneration paid to such a medical professional in any other capacity (other than for the performance of medical or veterinary services) is taken into account.

A covered employee is any current or former employee of an applicable tax-exempt organization if the employee is (1) one of the five highest compensated employees of the organization for the tax year, or (2) was a covered employee of the organization, or any predecessor of the organization, for any tax year after December 31, 2016.

Any remuneration for which a deduction under IRC section 162(m) is not allowed is not included in remuneration used to calculate this excise tax. Remuneration of a covered employee paid by an applicable tax-exempt organization includes any remuneration paid for employment to a covered employee by a related person or government entity. A person or government entity is considered to be related to an applicable tax-exempt organization if the person or entity:

Controls, or is controlled by, the applicable tax-exempt organization,
Is controlled by a person, or persons, that control the organization,
Is a supported organization under IRC section 509(f)(3),
Is a supporting organization under IRC section 509(a)(3), or
If the organization is a voluntary employees' beneficiary association (VEBA) under IRC section 509(c)(9), and establishes, maintains, or makes contributions to that VEBA.

[940] IRC section 115(1).
[941] IRC section 527(e)(1).

If remuneration from more than one employer is used to calculate the excise tax, then each employer will be liable for the amount determined by the following ratio:

The amount of remuneration paid by the employer to the employee, over
The total amount of remuneration paid by all such employers to the employee.

Excess Parachute Payment.

For purposes of this excise tax, an "excess parachute payment" is the amount that exceeds the excess of any "parachute payment" over the "base amount" allocated to the payment. A parachute payment is any payment made as compensation to, or for the benefit of, a covered employee if (1) the payment is contingent on the employee's separation from employment with the employer, and (2) the aggregate present value of the compensation payments to, or for the benefit of, the employee is equal to, or greater than, three times the base amount.

However, a parachute payment does not include any payment:

Described in IRC section 280G(b)(6), relating to the exemption for payments under qualified plans,
Made under or to an annuity contract under IRC section 403(b), or an IRC section 457(b) plan,
Made to a licensed medical professional (including veterinarians) to the extent that the payment is for services performed by that medical professional, or
Made to an individual who is not considered a highly compensated employee.[942]

For these purposes, the "base amount" is determined in the same manner as under IRC section 280G(b)(3), relating to the base amount for a golden parachute payment. For purposes of determining an excess parachute payment, the rules of IRC sections 280G(d)(3) and 280G(d)(4) apply.

The IRS is directed to prescribe regulations that may be necessary to prevent the avoidance of the excise tax, including regulations preventing employees from being misclassified as contractors, or from being compensated through a pass-through or other entity to avoid such tax.

Effective Dates

The provisions are effective for taxable years beginning after December 31, 2017.

California Law

The FTB does not administer these types of excise taxes.

[942] IRC section 414(g).

Impact on California Revenue

The FTB does not administer these types of excise taxes.

Section	Section Title
13603	Treatment of Qualified Equity Grants

Background

Income Tax Treatment of Employer Stock Transferred to an Employee

Specific rules apply to property, including employer stock, transferred to an employee in connection with the performance of services.[943] These rules govern the amount and timing of income inclusion by the employee and the amount and timing of the employer's compensation deduction.

Under these rules, an employee generally must recognize income in the taxable year in which the employee's right to the stock is transferable or is not subject to a substantial risk of forfeiture, whichever occurs earlier (referred to herein as "substantially vested"). Thus, if the employee's right to the stock is substantially vested when the stock is transferred to the employee, the employee recognizes income in the taxable year of such transfer, in an amount equal to the fair market value of the stock as of the date of transfer (less any amount paid for the stock). If at the time the stock is transferred to the employee, the employee's right to the stock is not substantially vested (referred to herein as "nonvested"), the employee does not recognize income attributable to the stock transfer until the taxable year in which the employee's right becomes substantially vested. In this case, the amount includible in the employee's income is the fair market value of the stock as of the date that the employee's right to the stock is substantially vested (less any amount paid for the stock). However, if the employee's right to the stock is nonvested at the time the stock is transferred to employee, under IRC section 83(b), the employee may elect within 30 days of transfer to recognize income in the taxable year of transfer, referred to as a "section 83(b)" election.[944] If a proper and timely election under IRC section 83(b) is made, the amount of compensatory income is capped at the amount equal to the fair market value of the stock as of the date of transfer (less any amount paid for the stock). An IRC section 83(b) election is available with respect to grants of "restricted stock" (nonvested stock), and does not generally apply to the grant of options.

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[943] IRC section 83. IRC section 83 applies generally to transfers of any property, not just employer stock, in connection with the performance of services by any service provider, not just an employee. However, the provision described herein applies only with respect to certain employer stock transferred to employees.
[944] Under Treasury Regulation sections 1.83-2, the employee makes an election by filing with the IRS a written statement that includes the fair market value of the property at the time of transfer and the amount (if any) paid for the property. The employee must also provide a copy of the statement to the employer.

In general, an employee's right to stock or other property is subject to a substantial risk of forfeiture if the employee's right to full enjoyment of the property is subject to a condition, such as the future performance of substantial services.[945] An employee's right to stock or other property is transferable if the employee can transfer an interest in the property to any person other than the transferor of the property.[946] Thus, generally, employer stock transferred to an employee by an employer is not transferable merely because the employee can sell it back to the employer.

In the case of stock transferred to an employee, the employer is allowed a deduction (to the extent a deduction for a business expense is otherwise allowable) equal to the amount included in the employee's income as a result of transfer of the stock.[947] The employer deduction generally is permitted in the employer's taxable year in which or with which ends the employee's taxable year when the amount is included and properly reported in the employee's income.[948]

These rules do not apply to the grant of a nonqualified option on employer stock unless the option has a readily ascertainable fair market value.[949] Instead, these rules apply to the transfer of employer stock by the employee on exercise of the option. That is, if the right to the stock is substantially vested on transfer (the time of exercise), income recognition applies for the taxable year of transfer. If the right to the stock is nonvested on transfer, the timing of income inclusion is determined under the rules applicable to the transfer of nonvested stock. In either case, the amount includible in income by the employee is the fair market value of the stock as of the required time of income inclusion, less the exercise price paid by the employee. An IRC section 83(b) election generally does not apply to the grant of options. If upon the exercise of an option, nonvested stock is transferred to the employee, an IRC section 83(b) election may apply. The employer's deduction is generally determined under the rules that apply to transfers of restricted stock, but a special accrual rule may apply under Treasury regulations when the transferred stock is substantially vested.[950]

Employment Taxes and Reporting

Employment taxes generally consist of taxes under the Federal Insurance Contributions Act (FICA), tax under the Federal Unemployment Tax Act (FUTA), and income taxes required to be withheld by employers from wages paid to employees ("income tax withholding").[951] Unless an exception applies under the applicable rules, compensation provided to an employee constitutes wages subject to these taxes.

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[945] See IRC section 83(c)(1) and Treasury Regulation sections 1.83-3(c) for the definition of substantial risk of forfeiture.
[946] See IRC section 83(c)(1) and Treasury Regulation sections 1.83-3(c) for the definition of substantial risk of forfeiture.
[947] IRC section 83(h).
[948] Treasury Regulation sections 1.83-6.
[949] See IRC section 83(e)(3) and Treasury Regulation sections 1.83-7. A nonqualified option is an option on employer stock that is not a statutory option, discussed below.
[950] Treasury Regulation sections 1.83-6(a)(3).
[951] IRC sections 3101-3128 (FICA), 3301-3311 (FUTA), and 3401-3404 (income tax withholding). Instead of FICA taxes, railroad employers and employees are subject, under the Railroad Retirement Tax Act (RRTA), IRC sections 3201-3241, to taxes equivalent to FICA taxes with respect to compensation as defined for RRTA purposes. IRC sections 3501-3510 provide additional rules relating to all these taxes.

FICA imposes tax on employers and employees, generally based on the amount of wages paid to an employee during the year. Special rules as to the timing and amount of FICA taxes apply in the case of nonqualified deferred compensation, as defined for FICA purposes.[952]

The tax imposed on the employer and on the employee is each composed of two parts: (1) the Social Security or old age, survivors, and disability insurance (OASDI) tax equal to 6.2 percent of covered wages up to the OASDI wage base ($127,200 for 2017); and (2) the Medicare or hospital insurance (HI) tax equal to 1.45 percent of all covered wages.[953] The employee portion of FICA tax generally must be withheld and, along with the employer portion, remitted to the Federal government by the employer. FICA tax withholding applies regardless of whether compensation is provided in the form of cash or a noncash form, such as a transfer of property (including employer stock) or in-kind benefits.[954]

FUTA imposes a tax on employers of six percent of wages up to the FUTA wage base of $7,000.

Income tax withholding generally applies when wages are paid by an employer to an employee, based on graduated withholding rates set out in tables published by the IRS.[955] Like FICA tax withholding, income tax withholding applies regardless of whether compensation is provided in the form of cash or a noncash form, such as a transfer of property (including employer stock) or in-kind benefits.

An employer is required to furnish each employee with a statement of compensation information for a calendar year, including taxable compensation, FICA wages, and withheld income and FICA taxes.[956] In addition, information relating to certain nontaxable items must be reported, such as certain retirement and health plan contributions. The statement, made on Form W-2, Wage and Tax Statement, must be provided to each employee by January 31 of the succeeding year.[957]

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[952] IRC section 3121(v); Treasury Regulation sections 31.3121(v)(2).

[953] The employee portion of the HI tax under FICA (not the employer portion) is increased by an additional tax of 0.9 percent on wages received in excess of a threshold amount. The threshold amount is $250,000 in the case of a joint return, $125,000 in the case of a married individual filing a separate return, and $200,000 in any other case.

[954] Under IRC section 3501(b), employment taxes with respect to noncash fringe benefits are to be collected (or paid) by the employer at the time and in the manner prescribed by the Secretary of the Treasury (Treasury). Announcement 85-113, 1985-31 I.R.B. 31, provides guidance on the application of employment taxes with respect to noncash fringe benefits.

[955] IRC section 3402. Specific withholding rates apply in the case of supplemental wages.

[956] IRC sections 6041 and 6051.

[957] Employers send Form W-2 information to the Social Security Administration, which records information relating to Social Security and Medicare and forwards the Form W-2 information to the IRS. Employees include a copy of Form W-2 with their income tax returns.

Statutory Options

Two types of statutory options apply with respect to employer stock: incentive stock options (ISOs) and options provided under an employee stock purchase plan (ESPP).[958] Stock received pursuant to a statutory option is subject to special rules, rather than the rules for nonqualified options, discussed above. No amount is includible in an employee's income on the grant, vesting, or exercise of a statutory option.[959] In addition, generally no deduction is allowed to the employer with respect to the option or the stock transferred to an employee.

If a holding requirement is met with respect to the stock transferred on exercise of a statutory option and the employee later disposes of the stock, the employee's gain generally is treated as capital gain rather than ordinary income. Under the holding requirement, the employee must not dispose of the stock within two years after the date the option is granted and also must not dispose of the stock within one year after the date the option is exercised. If a disposition occurs before the end of the required holding period (a "disqualifying disposition"), the employee recognizes ordinary income in the taxable year in which the disqualifying disposition occurs and the employer may be allowed a corresponding deduction in the taxable year in which such disposition occurs. The amount of ordinary income recognized when a disqualifying disposition occurs generally equals the fair market value of the stock on the date of exercise (that is, when the stock was transferred to the employee) less the exercise price paid.

Employment taxes do not apply with respect to the grant or vesting of a statutory option, transfer of stock pursuant to the option, or a disposition (including a disqualifying disposition) of the stock.[960] However, certain special reporting requirements apply.

Nonqualified Deferred Compensation

Compensation is generally includible in an employee's income when paid to the employee. However, in the case of a nonqualified deferred compensation plan,[961] unless the arrangement either is exempt from or meets the requirements of IRC section 409A, the amount of deferred compensation is first includible in income for the taxable year when not subject to a substantial risk of forfeiture (as defined[962]), even if payment will not occur until a later year.[963] In general, to

[958] IRC sections 421-424 govern statutory options. IRC section 423(b)(5) requires that, under the terms of an ESPP, all employees granted options generally must have the same rights and privileges.
[959] Under IRC section 56(b)(3), this income tax treatment with respect to stock received on exercise of an ISO does not apply for purposes of the AMT under IRC section 55.
[960] IRC sections 3121(a)(22), 3306(b)(19), and the last sentence of IRC section 421(b).
[961] Compensation earned by an employee is generally paid to the employee shortly after being earned. However, in some cases, payment is deferred to a later period, referred to as "deferred compensation." Deferred compensation may be provided through a plan that receives tax-favored treatment, such as a qualified retirement plan under IRC section 401(a). Deferred compensation provided through a plan that is not eligible for tax-favored treatment is referred to as "nonqualified" deferred compensation.
[962] Treasury Regulation sections 1.409A-1(d).
[963] IRC section 409A and the regulations thereunder provide rules for nonqualified deferred compensation. Compensation that fails to meet the requirements of IRC section 409A is also subject to an additional income tax of 20 percent on amounts includible in income and a potential interest factor tax (409A taxes). IRC section 409A and the additional 409A taxes apply to increases in the value of the failed compensation each year until it is paid.

meet the requirements of IRC section 409A, the time when nonqualified deferred compensation will be paid, as well as the amount, must be specified at the time of deferral with limits on further deferral after the time for payment. Various other requirements apply, including that payment can only occur on specific defined events.

Various exemptions from IRC section 409A apply, including transfers of property subject to IRC section 83.[964] Nonqualified options are not automatically exempt from IRC section 409A, but may be structured so as not to be considered nonqualified deferred compensation.[965] A restricted stock unit (RSU) is a term used for an arrangement under which an employee has the right to receive at a specified time in the future an amount determined by reference to the value of one or more shares of employer stock. An employee's right to receive the future amount may be subject to a condition, such as continued employment for a certain period or the attainment of certain performance goals. The payment to the employee of the amount due under the arrangement is referred to as settlement of the RSU. The arrangement may provide for the settlement amount to be paid in cash or as a transfer of employer stock (or either). An arrangement providing RSUs is generally considered a nonqualified deferred compensation plan and is subject to the rules, including the limits, of IRC section 409A. The employer deduction generally is permitted in the employer's taxable year in which or with which ends the employee's taxable year when the amount is included and properly reported in the employee's income.[966]

New Federal Law (IRC sections 83, 409A, 422, 423, 3401, 3402, 6051, and 6652)

In General

The provision allows a qualified employee to elect to defer, for income tax purposes, the inclusion in income of the amount of income attributable to qualified stock transferred to the employee by the employer. An election to defer income inclusion ("inclusion deferral election") with respect to qualified stock must be made no later than 30 days after the first time the employee's right to the stock is substantially vested or is transferable, whichever occurs earlier.

If an employee elects to defer income inclusion under the provision, the income must be included in the employee's income for the taxable year that includes the earliest of (1) the first date the qualified stock becomes transferable, including, solely for this purpose, transferable to the employer;[967] (2) the date the employee first becomes an excluded employee (as described below); (3) the first date on which any stock of the employer becomes readily tradable on an established securities market; [968] (4) the date five years after the first date the employee's right to the stock becomes substantially vested; or (5) the date on which the employee revokes her inclusion deferral election.[969]

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[964] Treasury Regulation sections 1.409A-1(b)(6).
[965] Treasury Regulation sections 1.409A-1(b)(5). In addition, statutory option arrangements are not nonqualified deferred compensation arrangements.
[966] IRC section 404(a)(5).
[967] Thus, for this purpose, the qualified stock is considered transferable if the employee has the ability to sell the stock to the employer (or any other person).
[968] An established securities market is determined for this purpose by the Secretary, but does not include any market unless the market is recognized as an established securities market for purposes of another Code provision.
[969] An inclusion deferral election is revoked at the time and in the manner as the Secretary provides.

An inclusion deferral election is made in a manner similar to the manner in which an IRC section 83(b) election is made.[970] The provision does not apply to income with respect to nonvested stock that is includible as a result of an IRC section 83(b) election. The provision clarifies that IRC section 83 (other than the provision), including subsection (b), shall not apply to RSUs. Therefore, RSUs are not eligible for an IRC section 83(b) election. This is the case because, absent this provision, RSUs are nonqualified deferred compensation and therefore subject to the rules that apply to nonqualified deferred compensation.

An employee may not make an inclusion deferral election for a year with respect to qualified stock if, in the preceding calendar year, the corporation purchased any of its outstanding stock unless at least 25 percent of the total dollar amount of the stock so purchased is stock with respect to which an inclusion deferral election is in effect ("deferral stock") and the determination of which individuals from whom deferral stock is purchased is made on a reasonable basis.[971] For purposes of this requirement, stock purchased from an individual is not treated as deferral stock (and the purchase is not treated as a purchase of deferral stock) if, immediately after the purchase, the individual holds any deferral stock with respect to which an inclusion deferral election has been in effect for a longer period than the election with respect to the purchased stock. Thus, in general, in applying the purchase requirement, an individual's deferral stock with respect to which an inclusion deferral election has been in effect for the longest periods must be purchased first. A corporation that has deferral stock outstanding as of the beginning of any calendar year and that purchases any of its outstanding stock during the calendar year must report on its income tax return for the taxable year in which, or with which, the calendar year ends the total dollar amount of the outstanding stock purchased during the calendar year and such other information as the Secretary may require for purposes of administering this requirement.

A qualified employee may make an inclusion deferral election with respect to qualified stock attributable to a statutory option.[972] In that case, the option is not treated as a statutory option and the rules relating to statutory options and related stock do not apply. In addition, an arrangement under which an employee may receive qualified stock is not treated as a nonqualified deferred compensation plan solely with respect to an employee who may receive qualified stock, such that when an inclusion deferral election is made in connection with the exercise of both ESPPs and ISOs, the options are not treated as statutory options but rather as nonqualified stock options for FICA purposes (in addition to being subject to section 83(i) for income tax purposes).

Deferred income inclusion applies also for purposes of the employer's deduction of the amount of income attributable to the qualified stock. That is, if an employee makes an inclusion deferral election, the employer's deduction is deferred until the employer's taxable year in which or with

[970] Thus, as in the case of an IRC section 83(b) election under present law, the employee must file with the IRS the inclusion deferral election and provide the employer with a copy.
[971] This requirement is met if the stock purchased by the corporation includes all the corporation's outstanding deferral stock.
[972] For purposes of the requirement that an ESPP provide employees with the same rights and privileges, the rules of the provision apply in determining which employees have the right to make an inclusion deferral election with respect to stock received under the ESPP.

which ends the taxable year of the employee for which the amount is included in the employee's income as described in (1)-(5) above.

Qualified Employee and Qualified Stock

Under the provision, a qualified employee means an individual who is not an excluded employee and who agrees, in the inclusion deferral election, to meet the requirements necessary (as determined by the Secretary) to ensure the income tax withholding requirements of the employer corporation with respect to the qualified stock (as described below) are met. For this purpose, an excluded employee with respect to a corporation is any individual (1) who was a one-percent owner of the corporation at any time during the current or 10 preceding calendar years,[973] (2) who is, or has been at any prior time, the chief executive officer or chief financial officer of the corporation or an individual acting in either capacity, (3) who is a family member of an individual described in (1) or (2),[974] or (4) who has been one of the four highest compensated officers of the corporation for the current or any of the 10 preceding taxable years.[975]

Qualified stock is any stock of a corporation if:

An employee receives the stock in connection with the exercise of an option or in settlement of an RSU, and

The option or RSU was granted by the corporation to the employee in connection with the performance of services and in a year in which the corporation was an eligible corporation (as described below).

However, qualified stock does not include any stock if, at the time the employee's right to the stock becomes substantially vested, the employee may sell the stock to, or otherwise receive cash in lieu of stock from, the corporation. Qualified stock can only be such if it relates to stock received in connection with options or RSUs, and does not include stock received in connection with other forms of equity compensation, including SARs or restricted stock.

A corporation is an eligible corporation with respect to a calendar year if (1) no stock of the employer corporation (or any predecessor) is readily tradable on an established securities market during any preceding calendar year,[976] and (2) the corporation has a written plan under which, in the calendar year, not less than 80 percent of all employees who provide services to the corporation in the United States (or any U.S. possession) are granted either stock options, or

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[973] One-percent owner status is determined under the top-heavy rules for qualified retirement plans, that is, IRC section 416(i)(1)(B)(ii).

[974] In the case of one-percent owners, this results from application of the attribution rules of IRC section 318 under IRC section 416(i)(1)(B)(i)(II). Family members are determined under IRC section 318(a)(1) and generally include an individual's spouse, children, grandchildren and parents.

[975] These officers are determined on the basis of shareholder disclosure rules for compensation under the Securities Exchange Act of 1934, as if such rules applied to the corporation.

[976] This requirement continues to apply up to the time an inclusion deferral election is made. That is, under the provision, no inclusion deferral election may be made with respect to qualified stock if any stock of the corporation is readily tradable on an established securities market at any time before the election is made.

RSUs, with the same rights and privileges to receive qualified stock ("80-percent requirement").[977] For this purpose, in general, the determination of rights and privileges with respect to stock is determined in a similar manner as provided under the present-law ESPP rules.[978] [979] However, employees will not fail to be treated as having the same rights and privileges to receive qualified stock solely because the number of shares available to all employees is not equal in amount, provided that the number of shares available to each employee is more than a de minimis amount. In addition, rights and privileges with respect to the exercise of a stock option are not treated for this purpose as the same as rights and privileges with respect to the settlement of an RSU.[980]

For purposes of the provision, corporations that are members of the same controlled group[981] are treated as one corporation.

Notice, Withholding and Reporting Requirements

Under the provision, a corporation that transfers qualified stock to a qualified employee must provide a notice to the qualified employee at the time (or a reasonable period before) the employee's right to the qualified stock is substantially vested (and income attributable to the stock would first be includible absent an inclusion deferral election). The notice must (1) certify to the employee that the stock is qualified stock, and (2) notify the employee (a) that the employee may (if eligible) elect to defer income inclusion with respect to the stock and (b) that, if the employee makes an inclusion deferral election, the amount of income required to be included at the end of the deferral period will be based on the value of the stock at the time the employee's right to the stock first becomes substantially vested, notwithstanding whether the value of the stock has declined during the deferral period (including whether the value of the stock has declined below the employee's tax liability with respect to such stock), and the amount of income to be included at the end of the deferral period will be subject to withholding as provided under the provision, as well as of the employee's responsibilities with respect to required withholding. Failure to provide the notice may result in the imposition of a penalty of $100 for each failure, subject to a maximum penalty of $50,000 for all failures during any calendar year.

An inclusion deferral election applies only for income tax purposes. The application of FICA and FUTA are not affected. The provision includes specific income tax withholding and reporting requirements with respect to income subject to an inclusion deferral election.

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[977] In applying the requirement that 80 percent of employees receive stock options or RSUs, excluded employees and part-time employees are not taken into account. For this purpose, part-time employee is defined under IRC section 4980G(d)(4), as an employee who is customarily employed for fewer than 30 hours per week.
[978] IRC section 423(b)(5).
[979] Under a transition rule, in the case of a calendar year beginning before January 1, 2018, the 80-percent requirement is applied without regard to whether the rights and privileges with respect to the qualified stock are the same.
[980] Under a transition rule, in the case of a calendar year beginning before January 1, 2018, the 80-percent requirement is applied without regard to whether the rights and privileges with respect to the qualified stock are the same.
[981] As defined in IRC section 414(b).

For the taxable year for which income subject to an inclusion deferral election is required to be included in income by the employee (as described above), the amount required to be included in income is treated as wages with respect to which the employer is required to withhold income tax at a rate not less than the highest income tax rate applicable to individual taxpayers.[982] The employer must report on Form W-2 the amount of income covered by an inclusion deferral election (1) for the year of deferral and (2) for the year the income is required to be included in income by the employee. In addition, for any calendar year, the employer must report on Form W-2 the aggregate amount of income covered by inclusion deferral elections, determined as of the close of the calendar year.

Effective Dates

The provision generally applies with respect to stock attributable to options exercised or RSUs settled after December 31, 2017. Under a transition rule, until the Secretary (or the Secretary's delegate) issues regulations or other guidance implementing the 80-percent and employer notice requirements under the provision, a corporation will be treated as complying with those requirements (respectively) if it complies with a reasonable good faith interpretation of the requirements. The penalty for a failure to provide the notice required under the provision applies to failures after December 31, 2017.

California Law (R&TC sections 17081, 17501, 17508.2, 24379, and 24601)

Treatment of Qualified Equity Grants

California conforms, under the PITL and the CTL, to the federal treatment of transfers of property in connection with the performance of services under IRC section 83, as of the "specified date" of January 1, 2015,[983] but does not conform to the federal modifications regarding the treatment of qualified equity grants.

Nonqualified Deferred Compensation Plans, Incentive Stock Options, and Employee Stock Purchase Plans

California conforms, under the PITL and the CTL, by reference to Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, consisting of Part I, relating to pension, profit-sharing, stock bonus plans, etc. (IRC sections 401 through 420) and Part II, relating to certain stock options (IRC sections 421 through 424), under R&TC sections 17501 and 24601.

However, R&TC sections 17501(b) and 24601(b) specifically provide that federal changes to

Part I of Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, consisting of IRC sections 401 through 420, automatically apply without regard to taxable year to the same extent as applicable for federal income tax purposes and thus adopt all changes made

[982] That is, the maximum rate of tax in effect for the year under IRC section 1. The provision specifies that qualified stock is treated as a noncash fringe benefit for income tax withholding purposes.
[983] R&TC section 17024.5.

to those IRC sections without regard to the "specified date" contained in R&TC sections 17024.5 and 23051.5.

Thus, the federal modifications to nonqualified deferred compensation[984] plans automatically apply under California law without regard to taxable year to the same extent as applicable for federal income tax purposes, while California does not conform to the federal modifications to incentive stock options[985] and employee stock purchase plans.[986]

Notice, Withholding and Reporting Requirements

California does not conform by reference to IRC section 3402, relating to income tax collected at source, but instead has stand-alone rules relating to income tax withholding.[987]

California does not conform by reference to IRC section 3401, relating to wage withholding. The EDD administers California's wage withholding program.

Impact on California Revenue

Estimated Conformity Revenue Impact of Treatment of Qualified Equity Grants For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	- $12,000,000	- $8,000,000	- $6,800,000

Section	Section Title
13604	Increase in Excise Tax Rate for Stock Compensation of Insiders in Expatriated Corporations

Background

Income Tax Treatment of Employee Stock Compensation

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[984] IRC section 409A.
[985] IRC section 422.
[986] IRC section 423.
[987] R&TC section 18662.

In General

Employers may grant various forms of stock compensation to employees,[988] including nonstatutory and statutory stock options, restricted stock, restricted stock units, and SARs. The tax treatment of these various forms of stock compensation depends on the specific terms and conditions of the arrangement and applicable rules.

Stock Compensation Treated as Property Transferred in Connection With the Performance of Services

IRC section 83 generally governs the taxation of transfers of any property in connection with the performance of services by any service provider. Typically, this encompasses the transfer of stock to an employee which is subject to conditions that amount to a substantial risk of forfeiture, called "restricted stock." IRC section 83 also generally governs the taxation of nonstatutory (or nonqualified) stock options. In general, an employee's right to stock or other property is subject to a substantial risk of forfeiture if the employee's right to full enjoyment of the property is subject to a condition, such as the future performance of substantial services.[989]

Generally, an employee must recognize income in the taxable year in which the employee's right to the stock is transferable or is not subject to a substantial risk of forfeiture, whichever occurs earlier (referred to herein as "substantially vested"). Thus, if the employee's right to the stock is substantially vested when the stock is transferred to the employee, the employee recognizes income in the taxable year of such transfer, in an amount equal to the fair market value of the stock as of the date of transfer (less any amount paid for the stock). If at the time the stock is transferred to the employee, the employee's right to the stock is not substantially vested (referred to herein as "nonvested"), the employee does not recognize income attributable to the stock transfer until the taxable year in which the employee's right becomes substantially vested. In this case, the amount includible in the employee's income is the fair market value of the stock as of the date that the employee's right to the stock is substantially vested (less any amount paid for the stock).[990]

These rules do not apply to the grant of a nonqualified option unless the option has a readily ascertainable fair market value.[991] Instead, these rules generally apply to the transfer of employer stock by the employee on exercise of the option. That is, if the right to the stock is substantially vested on transfer (the time of exercise), income recognition applies for the taxable year of transfer. If the right to the stock is nonvested on transfer, the timing of income inclusion is

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[988] The terms "employer" and "employee" are used, although the provision herein also applies to individuals who are not employees and the service recipients of such non-employee individuals.
[989] See IRC section 83(c)(1) and Treasury Regulation sections 1.83-3(c) for the definition of substantial risk of forfeiture.
[990] Under IRC section 83(b), the employee may elect within 30 days of transfer to recognize income in the taxable year of transfer, referred to as a "section 83(b)" election. If a proper and timely election under IRC section 83(b) is made, the amount of compensatory income is capped at the amount equal to the fair market value of the stock as of the date of transfer (less any amount paid for the stock).
[991] See IRC section 83(e)(3) and Treasury Regulation sections 1.83-7. A nonqualified option is an option on employer stock that is not a statutory option, discussed below.

determined under the rules applicable to the transfer of nonvested stock. In either case, the amount includible in income by the employee is the fair market value of the stock as of the required time of income inclusion, less the exercise price paid by the employee.

Statutory Stock Options

Two types of statutory options apply with respect to employer stock: incentive stock options ISOs and options provided under an employee stock purchase plan ESPP.[992] Stock received pursuant to a statutory option is subject to special rules, rather than the rules for nonqualified options, discussed above. Unlike nonqualified options, statutory options may only be considered as such if granted to employees.[993] No amount is includible in an employee's income on the grant, vesting, or exercise of a statutory option.

If a holding requirement is met with respect to the stock transferred on exercise of a statutory option and the employee later disposes of the stock, the employee's gain generally is treated as capital gain rather than ordinary income. Under the holding requirement, the employee must not dispose of the stock within two years after the date the option is granted and also must not dispose of the stock within one year after the date the option is exercised. If a disposition occurs before the end of the required holding period (a "disqualifying disposition"), the employee recognizes ordinary income in the taxable year in which the disqualifying disposition occurs. The amount of ordinary income recognized when a disqualifying disposition occurs generally equals the fair market value of the stock on the date of exercise (that is, when the stock was transferred to the employee) less the exercise price paid.

Stock Compensation Treated As Deferred Compensation

An RSU is a term used for an arrangement under which an employee has the right to receive at a specified time in the future an amount determined by reference to the value of one or more shares of employer stock. An employee's right to receive the future amount may be subject to a condition, such as continued employment for a certain period or the attainment of certain performance goals. The payment to the employee of the amount due under the arrangement is referred to as settlement of the RSU. The arrangement may provide for the settlement amount to be paid in cash or as a transfer of employer stock. An arrangement providing RSUs is generally considered a nonqualified deferred compensation plan and is subject to the rules, including the limits, of IRC section 409A,[994] unless it meets an exemption from IRC section 409A. If the RSU

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[992]IRC sections 421-424 govern statutory options. IRC section 423(b)(5) requires that, under the terms of an ESPP, all employees granted options generally must have the same rights and privileges.
[993] IRC sections 422(a)(2) and 423(a)(2).
[994] IRC section 409A and the regulations thereunder provide rules for nonqualified deferred compensation. Unless an arrangement either is exempt from or meets the requirements of IRC section 409A, the amount of deferred compensation is first includible in income for the taxable year when not subject to a substantial risk of forfeiture (as defined), even if payment will not occur until a later year. In general, to meet the requirements of IRC section 409A, the time when nonqualified deferred compensation will be paid, as well as the amount, must be specified at the time of deferral with limits on further deferral after the time for payment. Various other requirements apply, including that payment can only occur on specific defined events. Compensation that fails to meet the requirements of IRC section 409A is also subject to an additional income tax of 20 percent on amounts includible in income and a potential

either is exempt from or complies with IRC section 409A, the employee is subject to income taxation on receipt of cash or the transfer of shares attributable to the RSU.

A SAR is an arrangement under which an employee has the right to receive an amount (in the form of cash or stock) determined by reference to the appreciation in value of one or more shares of employer stock, based on the difference in the stock's value when the employee chooses to exercise the right and the value of the stock on the date of grant of the SAR. An SAR is generally taxable at the time of exercise on the amount of cash or value of stock transferred at the time of exercise of the SAR.[995]

Various exemptions from IRC section 409A apply, including transfers of property subject to IRC section 83, such as restricted stock.[996] Nonqualified options and SARs are not automatically exempt from IRC section 409A, but may be structured so as not to be considered nonqualified deferred compensation.[997] In addition, ISOs and ESPPs are exempt from IRC section 409A.[998]

IRC Section 4985 Excise Tax on Stock Compensation of Insiders of Expatriated Corporations

Under IRC section 4985, certain holders of stock options and other stock-based compensation are subject to an excise tax upon certain transactions that result in an expatriated corporation[999] (also referred to as corporate inversions).[1000] The provision imposes an excise tax, currently at the rate of 15 percent, on the value of specified stock compensation held (directly or indirectly) by or for the benefit of a disqualified individual, or a member of such individual's family, at any time during the 12-month period beginning six months before the corporation's expatriation date. Specified stock compensation is treated as held for the benefit of a disqualified individual if such compensation is held by an entity, *e.g.*, a partnership or trust, in which the individual, or a member of the individual's family, has an ownership interest.

A disqualified individual is any individual who, with respect to a corporation, is, at any time during the 12-month period beginning on the date which is six months before the expatriation date, subject to the requirements of section 16(a) of the Securities and Exchange Act of 1934 with respect to the corporation, or any member of the corporation's expanded affiliated group,[1001] or would be subject to such requirements if the corporation (or member) were an issuer of equity securities referred to in section 16(a). Disqualified individuals generally include officers (as

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interest factor tax (409A taxes). IRC section 409A and the additional 409A taxes apply to increases in the value of the failed compensation each year until it is paid.

[995] Revenue Ruling 80-300, 1980-2 C.B. 165.

[996] Treasury Regulation sections 1.409A-1(b)(6).

[997] Treasury Regulation sections 1.409A-1(b)(5).

[998] Treasury Regulation sections 1.409A-1(b)(5)(ii).

[999] IRC section 7874(a)(2).

[1000] For further discussion of the tax treatment of expatriated entities before the effective date of IRC section 7874 and concerns that led to the enactment of IRC sections 7874 and 4985, see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress* (JCS-5-05), May 2005.

[1001] An expanded affiliated group is an affiliated group (under IRC section 1504) except that such group is determined without regard to the exceptions for certain corporations and is determined by substituting "more than 50 percent" for "at least 80 percent."

defined by section 16(a)),[1002] directors, and 10-percent owners of private and publicly-held corporations.

The excise tax is imposed on a disqualified individual of an expatriated corporation (as defined for this purpose) only if gain is recognized in whole or part by any shareholder by reason of the acquisition resulting in the corporate inversion.[1003]

Specified stock compensation subject to the excise tax includes any payment (or right to payment)[1004] granted by the expatriated corporation (or any member of the corporation's expanded affiliated group) to any person in connection with the performance of services by a disqualified individual for such corporation (or member of the corporation's expanded affiliated group) if the value of the payment or right is based on, or determined by reference to, the value or change in value of stock of such corporation (or any member of the corporation's expanded affiliated group). In determining whether such compensation exists and valuing such compensation, all restrictions, other than non-lapse restrictions, are ignored. Thus, the excise tax applies, and the value subject to the tax is determined, without regard to whether such specified stock compensation is subject to a substantial risk of forfeiture or is exercisable at the time of the corporate inversion. Specified stock compensation includes compensatory stock and restricted stock grants, compensatory stock options, and other forms of stock-based compensation, including SARs, restricted stock units, phantom stock, and phantom stock options. Specified stock compensation also includes nonqualified deferred compensation that is treated as though it were invested in stock or stock options of the expatriating corporation (or member). For example, the provision applies to a disqualified individual's nonqualified deferred compensation if company stock is one of the actual or deemed investment options under the nonqualified deferred compensation plan.

Specified stock compensation includes a compensation arrangement that gives the disqualified individual an economic stake substantially similar to that of a corporate shareholder. A payment directly tied to the value of the stock is specified stock compensation.

The excise tax applies to any such specified stock compensation previously granted to a disqualified individual but cancelled or cashed-out within the six-month period ending with the expatriation date, and to any specified stock compensation awarded in the six-month period beginning with the expatriation date. As a result, for example, if a corporation cancels outstanding options three months before the transaction and then reissues comparable options three months after the transaction, the tax applies both to the cancelled options and the newly granted options.

Specified stock compensation subject to the tax does not include a statutory stock option or any payment or right from a qualified retirement plan or annuity, a tax-sheltered annuity, a simplified

[1002] An officer is defined as the president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions.
[1003] As referred to in IRC section 7874(a)(2)(B)(i).
[1004] Under the provision, any transfer of property is treated as a payment and any right to a transfer of property is treated as a right to a payment.

employee pension, or a simple retirement account. In addition, under the provision, the excise tax does not apply to any stock option that is exercised during the six-month period before the expatriation date or to any stock acquired pursuant to such exercise, if income is recognized under IRC section 83 on or before the expatriation date with respect to the stock acquired pursuant to such exercise. The excise tax also does not apply to any specified stock compensation that is exercised, sold, exchanged, distributed, cashed out, or otherwise paid during such period in a transaction in which income, gain, or loss is recognized in full.

For specified stock compensation held on the expatriation date, the amount of the tax is determined based on the value of the compensation on such date. The tax imposed on specified stock compensation cancelled during the six-month period before the expatriation date is determined based on the value of the compensation on the day before such cancellation, while specified stock compensation granted after the expatriation date is valued on the date granted. Under the provision, the cancellation of a non-lapse restriction is treated as a grant.

The value of the specified stock compensation on which the excise tax is imposed is the fair value in the case of stock options (including warrants and other similar rights to acquire stock) and SARs and the fair market value for all other forms of compensation. For purposes of the tax, the fair value of an option (or a warrant or other similar right to acquire stock) or an SAR is determined using an appropriate option-pricing model, as specified or permitted by the Treasury Secretary, that takes into account the stock price at the valuation date; the exercise price under the option; the remaining term of the option; the volatility of the underlying stock and the expected dividends on it; and the risk-free interest rate over the remaining term of the option. Options that have no intrinsic value (or "spread") because the exercise price under the option equals or exceeds the fair market value of the stock at valuation nevertheless have a fair value and are subject to tax under the provision. The value of other forms of compensation, such as phantom stock or restricted stock, is the fair market value of the stock as of the date of the expatriation transaction. The value of any deferred compensation that can be valued by reference to stock is the amount that the disqualified individual would receive if the plan were to distribute all such deferred compensation in a single sum on the date of the expatriation transaction (or the date of cancellation or grant, if applicable).

The excise tax also applies to any payment by the expatriated corporation or any member of the expanded affiliated group made to an individual, directly or indirectly, in respect of the tax. Whether a payment is made in respect of the tax is determined under all of the facts and circumstances. Any payment made to keep the individual in the same after-tax position that the individual would have been in had the tax not applied is a payment made in respect of the tax. This includes direct payments of the tax and payments to reimburse the individual for payment of the tax. Any payment made in respect of the tax is includible in the income of the individual, but is not deductible by the corporation.

To the extent that a disqualified individual is also a covered employee under IRC section 162(m), the limit on the deduction allowed for employee remuneration for such employee is reduced by the amount of any payment (including reimbursements) made in respect of the tax under the provision. As discussed above, this includes direct payments of the tax and payments to reimburse the individual for payment of the tax.

The payment of the excise tax has no effect on the subsequent tax treatment of any specified stock compensation. Thus, the payment of the tax has no effect on the individual's basis in any specified stock compensation and no effect on the tax treatment for the individual at the time of exercise of an option or payment of any specified stock compensation, or at the time of any lapse or forfeiture of such specified stock compensation. The payment of the tax is not deductible and has no effect on any deduction that might be allowed at the time of any future exercise or payment.

New Federal Law (IRC section 4985)

The provision increases the 15 percent rate of excise tax, imposed on the value of stock compensation held by insiders of an expatriated corporation, to 20 percent.

Effective Dates

The provision applies to corporations first becoming expatriated corporations after the date of enactment, December 22, 2017.

California Law

The FTB does not administer these types of excise taxes.

Impact on California Revenue

The FTB does not administer these types of excise taxes.

Subpart B—Retirement Plans

Section	Section Title
13611	Repeal of Special Rule Permitting Recharacterization of Roth Conversions

Background

Individual Retirement Arrangements (IRA)

There are two basic types of IRAs under present law: traditional IRAs,[1005] to which both deductible and nondeductible contributions may be made,[1006] and Roth IRAs, to which only nondeductible contributions may be made.[1007] The principal difference between these two types of IRAs is the timing of income tax inclusion.

An annual limit applies to contributions to IRAs. The contribution limit is coordinated so that the aggregate maximum amount that can be contributed to all of an individual's IRAs (both traditional and Roth) for a taxable year is the lesser of a certain dollar amount ($5,500 for 2017) or the individual's compensation. In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses is at least equal to the contributed amount. The dollar limit is increased annually ("indexed") as needed to reflect increases in the cost-of living. An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions up to $1,000 to an IRA. The IRA catch-up contribution limit is not indexed.

Traditional IRAs

An individual may make deductible contributions to a traditional IRA up to the IRA contribution limit (reduced by any contributions to Roth IRAs) if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. If an individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers with AGI for the taxable year over certain indexed levels.[1008] To the extent an individual cannot or does not make deductible contributions to a traditional IRA or contributions to a Roth IRA for the taxable year, the individual may make nondeductible after-tax contributions to a traditional IRA (that is, no AGI limits apply), subject to the same contribution limits as the limits on deductible contributions, including catch-up contributions. An individual who has attained age 70½ before to the close of a year is not permitted to make contributions to a traditional IRA for that year.

[1005] IRC section 408.
[1006] IRC sections 219(a) and 408(o).
[1007] IRC section 408A.
[1008] IRC section 219(g).

Amounts held in a traditional IRA are includible in income when withdrawn, except to the extent the withdrawal is a return of the individual's basis.[1009] All traditional IRAs of an individual are treated as a single contract for purposes of recovering basis in the IRAs.

Roth IRAs

Individuals with AGI below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with AGI for the taxable year over certain indexed levels.[1010]

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income. A qualified distribution is a distribution that (1) is made after the five-taxable-year period beginning with the first taxable year for which the individual first made a contribution to a Roth IRA, and (2) is made after attainment of age 59½, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings; amounts that are attributable to a return of contributions to the Roth IRA are not includible in income. All Roth IRAs are treated as a single contract for purposes of determining the amount that is a return of contributions.

Separation of Traditional and Roth IRA Accounts

Contributions to traditional IRAs and to Roth IRAs must be segregated into separate IRAs, meaning arrangements with separate trusts, accounts, or contracts, and separate IRA documents. Except in the case of a conversion or recharacterization, amounts cannot be transferred or rolled over between the two types of IRAs.

Taxpayers generally may convert an amount in a traditional IRA to a Roth IRA.[1011] The amount converted is includible in the taxpayer's income as if a withdrawal had been made.[1012] The conversion is accomplished by a trustee-to-trustee transfer of the amount from the traditional IRA to the Roth IRA, or by a distribution from the traditional IRA and contribution to the Roth IRA within 60 days.

[1009] Basis results from after-tax contributions to traditional IRAs or a rollovers to traditional IRAs of after- tax amounts from another eligible retirement plan.

[1010] Although an individual with AGI exceeding certain limits is not permitted to make a contribution directly to a Roth IRA, the individual can make a contribution to a traditional IRA and convert the traditional IRA to a Roth IRA, as discussed below.

[1011] Although an individual with AGI exceeding certain limits is not permitted to make a contribution directly to a Roth IRA, the individual can make a contribution to a traditional IRA and convert the traditional IRA to a Roth IRA.

[1012] Subject to various exceptions, distributions from an IRA before age 59½ that are includible in income are subject to a 10-percent early distribution tax under IRC section 72(t). An exception applies to an amount includible in income as a result of the conversion from a traditional IRA into a Roth IRA. However, the early distribution tax applies if the taxpayer withdraws the amount within five years of the conversion.

Rollovers to IRAs of distributions from tax-favored employer-sponsored retirement plans (that is, qualified retirement plans, tax-deferred annuity plans, and governmental eligible deferred compensation plans[1013]) are also permitted. For tax-free rollovers, distributions from pretax accounts under an employer-sponsored plan generally must are contributed to a traditional IRA, and distributions from a designated Roth account under an employer-sponsored plan must be contributed only to a Roth IRA. However, a distribution from an employer-sponsored plan that is not from a designated Roth account is also permitted to be rolled over into a Roth IRA, subject to the rules that apply to conversions from a traditional IRA into a Roth IRA. Thus, a rollover from a tax-favored employer-sponsored plan to a Roth IRA is includible in gross income (except to the extent it represents a return of after-tax contributions).[1014]

Recharacterization of IRA Contributions

If an individual makes a contribution to an IRA (traditional or Roth) for a taxable year, the individual is permitted to recharacterize the contribution as a contribution to the other type of IRA (traditional or Roth) by making a trustee-to-trustee transfer to the other type of IRA before the due date for the individual's income tax return for that year.[1015] In the case of a recharacterization, the contribution will be treated as having been made to the transferee IRA (and not the original, transferor IRA) as of the date of the original contribution. Both regular contributions and conversion contributions to a Roth IRA can be recharacterized as having been made to a traditional IRA.

The amount transferred in a recharacterization must be accompanied by any net income allocable to the contribution. In general, even if a recharacterization is accomplished by transferring a specific asset, net income is calculated as a pro rata portion of income on the entire account rather than income allocable to the specific asset transferred. However, when doing a Roth conversion of an amount for a year, an individual may establish multiple Roth IRAs, for example, Roth IRAs with different investment strategies, and divide the amount being converted among the IRAs. The individual can then choose whether to recharacterize any of the Roth IRAs as a traditional IRA by transferring the entire amount in the particular Roth IRA to a traditional IRA.[1016] For example, if the value of the assets in a particular Roth IRA declines after the conversion, the conversion can be reversed by recharacterizing that IRA as a traditional IRA. The individual may then later convert that traditional IRA to a Roth IRA (referred to as a reconversion), including only the lower value in income. Treasury regulations prevent the reconversion from taking place immediately after the recharcterization, by requiring a minimum period to elapse before the reconversion. Generally the reconversion cannot occur sooner than the later of 30 days after the recharacterization or a date during the taxable year following the taxable year of the original conversion.[1017]

[1013] IRC sections 401(a), 403(a), 403(b) and 457(b).
[1014] As in the case of a conversion of an amount from a traditional IRA to a Roth IRA, the special recapture rule relating to the 10-percent additional tax on early distributions applies for distributions made from the Roth IRA within a specified five-year period after the rollover.
[1015] IRC section 408A(d)(6).
[1016] Treasury Regulation sections 1.408A-5, Q&A-2(b).
[1017] Treasury Regulation sections 1.408A-5, Q&A-9.

New Federal Law (IRC section 408A)

Under the provision, the special rule that allows a contribution to one type of IRA to be recharacterized as a contribution to the other type of IRA does not apply to a conversion contribution to a Roth IRA. Thus, recharacterization cannot be used to unwind a Roth conversion. However, recharacterization is still permitted with respect to other contributions. For example, an individual may make a contribution for a year to a Roth IRA and, before the due date for the individual's income tax return for that year, recharacterize it as a contribution to a traditional IRA.[1018]

Effective Dates

The provision is effective for taxable years beginning after December 31, 2017.

California Law (R&TC sections 17501 and 24601)

California conforms, under the PITL and the CTL, by reference to Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, consisting of Part I, relating to pension, profit-sharing, stock bonus plans, etc. (IRC sections 401 through 420) and Part II, relating to certain stock options (IRC sections 421 through 424), under R&TC sections 17501 and 24601.

However, R&TC sections 17501(b) and 24601(b) specifically provide that federal changes to Part I of Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, consisting of IRC sections 401 through 420, automatically apply without regard to taxable year to the same extent as applicable for federal income tax purposes and thus adopt all changes made to those IRC sections without regard to the "specified date" contained in R&TC sections 17024.5 and 23051.5.

Thus, the federal repeal of the special rule permitting recharacterization of Roth conversions automatically applies under California law without regard to taxable year to the same extent as applicable for federal income tax purposes.

Impact on California Revenue

Baseline.

[1018] In addition, an individual may still make a contribution to a traditional IRA and convert the traditional IRA to a Roth IRA, but the provision precludes the individual from later unwinding the conversion through a recharacterization.

Section	Section Title
13612	Modification of Rules Applicable to Length of Service Award Plans

Background

Special rules apply to deferred compensation plans of State and local government and private, tax-exempt employers.[1019] However, an exception to these rules applies in the case of a plan paying solely length of service awards to bona fide volunteers (or their beneficiaries) on account of qualified services performed by the volunteers. For this purpose, qualified services consist of firefighting and fire prevention services, emergency medical services, and ambulance services. An individual is treated as a bona fide volunteer for this purpose if the only compensation received by the individual for performing qualified services is in the form of (1) reimbursement or a reasonable allowance for reasonable expenses incurred in the performance of such services, or (2) reasonable benefits (including length of service awards) and nominal fees for the services, customarily paid in connection with the performance of such services by volunteers. The exception applies only if the aggregate amount of length of service awards accruing for a bona fide volunteer with respect to any year of service does not exceed $3,000.

New Federal Law (IRC section 457)

The provision increases the aggregate amount of length of service awards that may accrue for a bona fide volunteer with respect to any year of service to $6,000 and adjusts that amount in $500 increments to reflect changes in cost-of-living for years after the first year the provision is effective. In addition, under the provision, if the plan is a defined benefit plan, the limit applies to the actuarial present value of the aggregate amount of length of service awards accruing with respect to any year of service. Actuarial present value is to be calculated using reasonable actuarial assumptions and methods, assuming payment will be made under the most valuable form of payment under the plan with payment commencing at the later of the earliest age at which unreduced benefits are payable under the plan or the participant's age at the time of the calculation.

Effective Dates

The amendments to this provision are effective for taxable years beginning after December 31, 2017.

California Law (R&TC section 17551)

California conforms, under the PITL, by reference to Subchapter E of Chapter 1 of Subtitle A of the IRC, relating to accounting periods and methods of accounting, consisting of IRC sections 441 through 483, inclusive, in R&TC section 17551(a) as of the "specified date" of January 1, 2015.[1020]

[1019] IRC section 457.
[1020] R&TC section 17024.5.

R&TC section 17551(c) specifically provides that federal changes to Subchapter E of Chapter 1 of Subtitle A of the IRC, consisting of IRC sections 441 through 483, inclusive, relating to accounting periods and methods of accounting, shall apply without regard to taxable year to the same extent as applicable for federal income tax purposes and thus adopt all changes made to those IRC sections without regard to the "specified date" contained in R&TC section 17024.5.

The federal changes to IRC section 457 made by this provision are applicable for California purposes without regard to taxable year to the same extent as applicable for federal income tax purposes.

Impact on California Revenue

Baseline.

Section	Section Title
13613	Extended Rollover Period for Plan Loan Offset Amounts

Background

Taxation of Retirement Plan Distributions

A distribution from a tax-favored employer-sponsored retirement plan (that is, a qualified retirement plan, IRC section 403(b) plan, or a governmental IRC section 457(b) plan) is generally includible in gross income, except in the case of a qualified distribution from a designated Roth account or to the extent the distribution is a recovery of basis under the plan or the distribution is contributed to another such plan or an IRA (referred to as eligible retirement plans) in a tax-free rollover.[1021] In the case of a distribution from a retirement plan to an employee under age $59^1/_2$, the distribution (other than a distribution from a governmental IRC section 457(b) plan) is also subject to a 10-percent early distribution tax unless an exception applies.[1022]

A distribution from a tax-favored employer-sponsored retirement plan that is an eligible rollover distribution may be rolled over to an eligible retirement plan.[1023] The rollover generally can be achieved by direct rollover (direct payment from the distributing plan to the recipient plan) or by contributing the distribution to the eligible retirement plan within 60 days of receiving the distribution ("60-day rollover").

Employer-sponsored retirement plans are required to offer an employee a direct rollover with respect to any eligible rollover distribution before paying the amount to the employee. If an

[1021] IRC sections 402(a) and (c), 402A(d), 403(a) and (b), 457(a) and (e)(16).
[1022] IRC section 72(t).
[1023] Certain distributions are not eligible rollover distributions, such as annuity payments, required minimum distributions, hardship distributions, and loans that are treated as deemed distributions under IRC section 72(p).

eligible rollover distribution is not directly rolled over to an eligible retirement plan, the taxable portion of the distribution generally is subject to mandatory 20-percent income tax withholding.[1024]

Employees who do not elect a direct rollover but who roll over eligible distributions within 60 days of receipt also defer tax on the rollover amounts; however, the 20 percent withheld will remain taxable unless the employee substitutes funds within the 60-day period.

Plan Loans

Employer-sponsored retirement plans may provide loans to employees. Unless the loan satisfies certain requirements in both form and operation, the amount of a retirement plan loan is a deemed distribution from the retirement plan, including that the terms of the loan provide for a repayment period of not more than five years (except for a loan specifically to purchase a home) and for level amortization of loan payments with payments not less frequently than quarterly.[1025] Thus, if an employee stops making payments on a loan before the loan is repaid, a deemed distribution of the outstanding loan balance generally occurs. A deemed distribution of an unpaid loan balance is generally taxed as though an actual distribution occurred, including being subject to a 10-percent early distribution tax, if applicable. A deemed distribution is not eligible for rollover to another eligible retirement plan.

A plan may also provide that, in certain circumstances (for example, if an employee terminates employment), an employee's obligation to repay a loan is accelerated and, if the loan is not repaid, the loan is cancelled and the amount of the employee's account balance is offset by the amount of the unpaid loan balance, referred to as a loan offset. A loan offset is treated as an actual distribution from the plan equal to the unpaid loan balance (rather than a deemed distribution), and (unlike a deemed distribution) the amount of the distribution is eligible for tax-free rollover to another eligible retirement plan within 60 days. However, the plan is not required to offer a direct rollover with respect to a plan loan offset amount that is an eligible rollover distribution, and the plan loan offset amount is generally not subject to 20-percent income tax withholding.

<u>New Federal Law (IRC section 402)</u>

Under the provision, the period during which a qualified plan loan offset amount may be contributed to an eligible retirement plan as a rollover contribution is extended from 60 days after the date of the offset to the due date (including extensions) for filing the federal income tax return for the taxable year in which the plan loan offset occurs, that is, the taxable year in which the amount is treated as distributed from the plan. A qualified plan loan offset amount is a plan loan offset amount that is treated as distributed from a qualified retirement plan, a IRC section 403(b) plan or a governmental IRC section 457(b) plan solely by reason of the termination of the plan or the failure to meet the repayment terms of the loan because of the employee's severance from

[1024] Treasury Regulation sections 1.402(c)-2, QA-1(b)(3).
[1025] IRC section 72(p).

employment. As under present law, a loan offset amount under the provision is the amount by which an employee's account balance under the plan is reduced to repay a loan from the plan.

Effective Dates

The provision is effective for plan loan offset amounts treated as distributed in taxable years beginning after December 31, 2017.

California Law (R&TC section 17501 and 24601)

California conforms, under the PITL and the CTL, by reference to Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, consisting of Part I, relating to pension, profit-sharing, stock bonus plans, etc. (IRC sections 401 through 420) and Part II, relating to certain stock options (IRC sections 421 through 424), in R&TC sections 17501 and 24601.

However, R&TC sections 17501(b) and 24601(b) specifically provide that federal changes to Part I of Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to deferred compensation, consisting of IRC sections 401 through 420, automatically apply without regard to taxable year to the same extent as applicable for federal income tax purposes and thus adopt all changes made to those IRC sections without regard to the “specified date” contained in R&TC sections 17024.5 and 23051.5.

Thus, the federal extended rollover period for plan loan offset amounts automatically applies under California law without regard to taxable year to the same extent as applicable for federal income tax purposes.

Impact on California Revenue

Baseline.

Part VIII—Exempt Organizations

Section	Section Title
13701	Excise Tax Based on Investment Income of Private Colleges and Universities

Background

Public Charities and Private Foundations

An organization qualifying for tax-exempt status under IRC section 501(c)(3) is further classified as either a public charity or a private foundation. An organization may qualify as a public charity in several ways.[1026] Certain organizations are classified as public charities per se, regardless of their sources of support. These include churches, certain schools, hospitals and other medical organizations, certain organizations providing assistance to colleges and universities, and governmental units.[1027] Other organizations qualify as public charities because they are broadly publicly supported. First, a charity may qualify as publicly supported if at least one-third of its total support is from gifts, grants or other contributions from governmental units or the general public.[1028] Alternatively, it may qualify as publicly supported if it receives more than one-third of its total support from a combination of gifts, grants, and contributions from governmental units and the public plus revenue arising from activities related to its exempt purposes (e.g., fee for service income). In addition, this category of public charity must not rely excessively on endowment income as a source of support.[1029] A supporting organization, i.e., an organization that provides support to another IRC section 501(c)(3) entity that is not a private foundation and meets the requirements of the IRC, also is classified as a public charity.[1030]

An IRC section 501(c)(3) organization that does not fit within any of the above categories is a private foundation. In general, private foundations receive funding from a limited number of sources (e.g., an individual, a family, or a corporation).

The deduction for charitable contributions to private foundations is in some instances less generous than the deduction for charitable contributions to public charities. In addition, private foundations are subject to a number of operational rules and restrictions that do not apply to public charities.[1031]

[1026] The IRC does not expressly define the term "public charity," but rather provides exceptions to those entities that are treated as private foundations.

[1027] IRC section 509(a)(1) (referring to IRC sections 170(b)(1)(A)(i) through (iv) for a description of these organizations).

[1028] Treasury Regulation sections 1.170A-9(f)(2). Failing this mechanical test, the organization may qualify as a public charity if it passes a "facts and circumstances" test. Treasury Regulation sections 1.170A-9(f)(3).

[1029] To meet this requirement, the organization must normally receive more than one-third of its support from a combination of (1) gifts, grants, contributions, or membership fees and (2) certain gross receipts from admissions, sales of merchandise, performance of services, and furnishing of facilities in connection with activities that are related to the organization's exempt purposes. IRC section 509(a)(2)(A). In addition, the organization must not normally receive more than one-third of its public support in each taxable year from the sum of (1) gross investment income and (2) the excess of unrelated business taxable income as determined under IRC section 512 over the amount of unrelated business income tax imposed by IRC section 511. IRC section 509(a)(2)(B).

[1030] IRC section 509(a)(3). Supporting organizations are further classified as Type I, II, or III depending on the relationship they have with the organizations they support. Supporting organizations must support public charities listed in one of the other categories (*i.e., per se* public charities, broadly supported public charities, or revenue generating public charities), and they are not permitted to support other supporting organizations or testing for public safety organizations. Organizations organized and operated exclusively for testing for public safety also are classified as public charities. IRC section 509(a)(4). Such organizations, however, are not eligible to receive deductible charitable contributions under IRC section 170.

[1031] Unlike public charities, private foundations are subject to tax on their net investment income at a rate of two percent (one percent in some cases). IRC section 4940. Private foundations also are subject to more restrictions on their activities than are public charities. For example, private foundations are prohibited from engaging in self-dealing transactions (IRC section 4941), are required to make a minimum amount of charitable distributions each year, (IRC section 4942), are limited in the extent to which they may control a business (IRC section 4943), may not make speculative investments (IRC section 4944), and may not make certain expenditures (IRC

Excise Tax on Investment Income of Private Foundations

Under IRC section 4940(a), private foundations that are recognized as exempt from Federal income tax under IRC section 501(a) (other than exempt operating foundations)[1032] are subject to a two-percent excise tax on their net investment income. Net investment income generally includes interest, dividends, rents, royalties (and income from similar sources), and capital gain net income, and is reduced by expenses incurred to earn this income. The two-percent rate of tax is reduced to one-percent in any year in which a foundation exceeds the average historical level of its charitable distributions. Specifically, the excise tax rate is reduced if the foundation's qualifying distributions (generally, amounts paid to accomplish exempt purposes)[1033] equal or exceed the sum of (1) the amount of the foundation's assets for the taxable year multiplied by the average percentage of the foundation's qualifying distributions over the five taxable years immediately preceding the taxable year in question, and (2) one percent of the net investment income of the foundation for the taxable year.[1034] In addition, the foundation cannot have been subject to tax in any of the five preceding years for failure to meet minimum qualifying distribution requirements in IRC section 4942.

Private foundations that are not exempt from tax under IRC section 501(a), such as certain charitable trusts, are subject to an excise tax under IRC section 4940(b). The tax is equal to the excess of the sum of the excise tax that would have been imposed under IRC section 4940(a) if the foundation were tax-exempt and the amount of the tax on unrelated business income that would have been imposed if the foundation were tax-exempt, over the income tax imposed on the foundation under subtitle A of the IRC.

Private foundations are required to make a minimum amount of qualifying distributions each year to avoid tax under IRC section 4942. The minimum amount of qualifying distributions a foundation has to make to avoid tax under IRC section 4942 is reduced by the amount of IRC section 4940 excise taxes paid.[1035]

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section 4945). Violations of these rules result in excise taxes on the foundation and, in some cases, may result in excise taxes on the managers of the foundation.

[1032] Exempt operating foundations are exempt from the IRC section 4940 tax. IRC section 4940(d)(1). Exempt operating foundations generally include organizations such as museums or libraries that devote their assets to operating charitable programs but have difficulty meeting the "public support" tests necessary not to be classified as a private foundation. To be an exempt operating foundation, an organization must: (1) be an operating foundation (as defined in IRC section 4942(j)(3)); (2) be publicly supported for at least 10 taxable years; (3) have a governing body no more than 25 percent of whom are disqualified persons and that is broadly representative of the general public; and (4) have no officers who are disqualified persons. IRC section 4940(d)(2).

[1033] IRC section 4942(g).

[1034] IRC section 4940(e).

[1035] IRC section 4942(d)(2).

Private Colleges and Universities

Private colleges and universities generally are treated as public charities rather than private foundations[1036] and thus are not subject to the private foundation excise tax on net investment income.

New Federal Law (IRC section 4968)

The provision imposes an excise tax on an applicable educational institution for each taxable year equal to 1.4 percent of the net investment income of the institution for the taxable year. Net investment income is determined using rules similar to the rules of IRC section 4940(c) (relating to the net investment income of a private foundation).

For purposes of the provision, an applicable educational institution is an institution: (1) that has at least 500 students during the preceding taxable year; (2) that is an eligible education institution as described in section 25A of the IRC;[1037] (3) that is not described in the first section of section 511(a)(2)(B) of the IRC (generally describing State colleges and universities); (4) the aggregate fair market value of the assets of which at the end of the preceding taxable year (other than those assets that are used directly in carrying out the institution's exempt purpose[1038]) is at least $500,000 per student; and (5) more than 50 percent of the students of which are located in the United States. For this purpose, the number of students at a location is based on the daily average number of full-time students attending the institution, with part-time students being taken into account on a full-time student equivalent basis.

For purposes of determining whether an institution meets the asset-per-student threshold and determining net investment income, assets and net investment income include amounts with respect to an organization that is related to the institution. An organization is treated as related to the institution for this purpose if the organization: (1) controls, or is controlled by, the institution; (2) is controlled by one or more persons that control the institution; or (3) is a supported organization[1039] or a supporting organization[1040] during the taxable year with respect to the institution. In addition, (1) no such amount is taken into account with respect to more than one educational institution; and (2) unless the related organization is controlled by the educational institution or is a supporting organization (described in IRC section 509(a)(3)) with respect to the institution for the taxable year, assets and investment income that are not intended or available for the use or benefit of the educational institution are not taken into account. For example, assets of a related organization that are earmarked or restricted for (or fairly attributable to) the educational institution would be treated as assets of the educational institution, whereas assets

[1036] IRC sections 509(a)(1) and 170(b)(1)(A)(ii).
[1037] IRC section 25A defines an eligible educational institution as an institution (1) which is described in IRC section 481 of the Higher Education Act of 1965 (20 U.S.C. section 1088), as in effect on August 5, 1977, and (2) which is eligible to participate in a program under title IV of such Act.
[1038] Assets used directly in carrying out the institution's exempt purpose include, for example, classroom buildings and physical facilities used for educational activities and office equipment or other administrative assets used by employees of the institution in carrying out exempt activities, among other assets.
[1039] IRC section 509(f)(3).
[1040] IRC section 509(a)(3).

of a related organization that are held for unrelated purposes (and are not fairly attributable to the educational institution) would be disregarded.

The Secretary shall promulgate regulations to carry out the intent of the provision, including regulations that describe: (1) assets that are used directly in carrying out the educational institution's exempt purpose; (2) the computation of net investment income; and (3) assets that are intended or available for the use or benefit of the educational institution.

Effective Dates

The provision is effective for taxable years beginning after December 31, 2017.

California Law

The FTB does not administer these types of excise taxes.

Impact on California Revenue

The FTB does not administer these types of excise taxes.

Section	Section Title
13702	Unrelated Business Taxable Income Separately Computed for Each Trade or Business Activity

Background

Tax Exemption for Certain Organizations

IRC section 501(a) exempts certain organizations from Federal income tax. Such organizations include: (1) tax-exempt organizations described in IRC section 501(c) (including among others IRC section 501(c)(3) charitable organizations and IRC section 501(c)(4) social welfare organizations); (2) religious and apostolic organizations described in IRC section 501(d); and (3) trusts forming part of a pension, profit-sharing, or stock bonus plan of an employer described in IRC section 401(a).

Unrelated Business Income Tax, In General

An exempt organization generally may have revenue from four sources: contributions, gifts, and grants; trade or business income that is related to exempt activities (e.g., program service revenue); investment income; and trade or business income that is not related to exempt activities. The Federal income tax exemption generally extends to the first three categories, and does not extend to an organization's unrelated trade or business income. In some cases, however, the investment income of an organization is taxed as if it were unrelated trade or business income.[1041]

The unrelated business income tax (UBIT) generally applies to income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization's tax-exempt functions.[1042] An organization that is subject to UBIT and that has $1,000 or more of gross unrelated business taxable income must report that income on Form 990-T (Exempt Organization Business Income Tax Return).

Most exempt organizations may operate an unrelated trade or business so long as the organization remains primarily engaged in activities that further its exempt purposes. Therefore, an organization may engage in a substantial amount of unrelated business activity without jeopardizing exempt status. An IRC section 501(c)(3) (charitable) organization, however, may not operate an unrelated trade or business as a substantial part of its activities.[1043] Therefore, the unrelated trade or business activity of an IRC section 501(c)(3) organization must be insubstantial.

Organizations Subject to Tax on Unrelated Business Income

Most exempt organizations are subject to the tax on unrelated business income. Specifically, organizations subject to the unrelated business income tax generally include: (1) organizations exempt from tax under IRC section 501(a), including organizations described in IRC section 501(c) (except for U.S. instrumentalities and certain charitable trusts);[1044] (2) qualified pension, profit-sharing, and stock bonus plans described in IRC section 401(a);[1045] and (3) certain State colleges and universities.[1046]

Exclusions from Unrelated Business Taxable Income

Certain types of income are specifically exempt from unrelated business taxable income, such as dividends, interest, royalties, and certain rents,[1047] unless derived from debt-financed property or from certain 50-percent controlled subsidiaries.[1048] Other exemptions from UBIT are provided for activities in which substantially all the work is performed by volunteers, for income from the sale of donated goods, and for certain activities carried on for the convenience of members, students, patients, officers, or employees of a charitable organization. In addition, special UBIT provisions exempt from tax activities of trade shows and State fairs, income from bingo games, and income from the distribution of low-cost items incidental to the solicitation of charitable contributions.

[1041] This is the case for social clubs (IRC section 501(c)(7)), voluntary employees' beneficiary associations (IRC section 501(c)(9)), and organizations and trusts described in IRC sections 501(c)(17) and 501(c)(20). IRC section 512(a)(3).
[1042] IRC sections 511-514.
[1043] Treasury Regulation sections 1.501(c)(3)-1(e).
[1044] IRC section 511(a)(2)(A).
[1045] IRC section 511(a)(2)(A).
[1046] IRC section 511(a)(2)(B).
[1047] IRC sections 511-514.
[1048] IRC section 512(b)(13).

Organizations liable for tax on unrelated business taxable income may be liable for AMT determined after taking into account adjustments and tax preference items.

Specific Deduction against Unrelated Business Taxable Income

In computing unrelated business taxable income, an exempt organization may take a specific deduction of $1,000. This specific deduction may not be used to create a net operating loss that will be carried back or forward to another year.[1049]

In the case of a diocese, province or religious order, or a convention or association of churches, a specific deduction is allowed with respect to each parish, individual church, district, or other local unit. The specific deduction is equal to the lower of $1,000 or the gross income derived from any unrelated trade or business regularly carried on by the local unit.[1050]

Operation of Multiple Unrelated Trades or Businesses

An organization determines its unrelated business taxable income by subtracting from its gross unrelated business income deductions directly connected with the unrelated trade or business.[1051] Under regulations, in determining unrelated business taxable income, an organization that operates multiple unrelated trades or businesses aggregates income from all such activities and subtracts from the aggregate gross income the aggregate of deductions.[1052] As a result, an organization may use a deduction from one unrelated trade or business to offset income from another, thereby reducing total unrelated business taxable income.

<u>New Federal Law (IRC section 512)</u>

For an organization with more than one unrelated trade or business, the provision requires that unrelated business taxable income first be computed separately with respect to each trade or business and without regard to the specific deduction generally allowed under IRC section 512(b)(12). The organization's unrelated business taxable income for a taxable year is the sum of the amounts (not less than zero) computed for each separate unrelated trade or business, less the specific deduction allowed under IRC section 512(b)(12). A net operating loss deduction is allowed only with respect to a trade or business from which the loss arose.

The result of the provision is that a deduction from one trade or business for a taxable year may not be used to offset income from a different unrelated trade or business for the same taxable year. The provision generally does not, however, prevent an organization from using a deduction from one taxable year to offset income from the same unrelated trade or business activity in another taxable year, where appropriate.

[1049] IRC section 512(b)(12).
[1050] Ibid.
[1051] IRC section 512(a).
[1052] Treasury Regulation sections 1.512(a)-1(a).

Effective Dates

The provision is effective for taxable years beginning after December 31, 2017. Under a special transition rule, net operating losses arising in a taxable year beginning before January 1, 2018, that are carried forward to a taxable year beginning on or after such date, are not subject to the general rule of the provision.

California Law (IRC section 23732)

California conforms, under the CTL, to the federal rules that apply to "unrelated business taxable income" under IRC section 512, as of the "specified date" of January 1, 2015,[1053] with modifications, but does not conform to the requirement that "unrelated business taxable income" be separately computed for each trade or business activity.

Impact on California Revenue

Estimated Conformity Revenue Impact of Unrelated Business Taxable Income Separately Computed for Each Trade or Business Activity For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	$12,000,000	$11,000,000	$10,000,000

Section	Section Title
13703	Unrelated Business Taxable Income Increased by Amount of Certain Fringe Benefit Expenses for Which Deduction is Disallowed

Background

Tax Exemption for Certain Organizations

IRC section 501(a) exempts certain organizations from Federal income tax. Such organizations include: (1) tax-exempt organizations described in IRC section 501(c) (including among others IRC section 501(c)(3) charitable organizations and IRC section 501(c)(4) social welfare organizations); (2) religious and apostolic organizations described in IRC section 501(d); and (3) trusts forming part of a pension, profit-sharing, or stock bonus plan of an employer described in IRC section 401(a).

[1053] R&TC section 23051.5.

Unrelated Business Income Tax, In General

The unrelated business income tax ("UBIT") generally applies to income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization's tax-exempt functions.[1054] An organization that is subject to UBIT and that has $1,000 or more of gross unrelated business taxable income must report that income on Form 990-T (Exempt Organization Business Income Tax Return).

Most exempt organizations may operate an unrelated trade or business so long as the organization remains primarily engaged in activities that further its exempt purposes. Therefore, an organization may engage in a substantial amount of unrelated business activity without jeopardizing its exempt status. An IRC section 501(c)(3) (charitable) organization, however, may not operate an unrelated trade or business as a substantial part of its activities.[1055] Therefore, the unrelated trade or business activity of an IRC section 501(c)(3) organization must be insubstantial.

An organization determines its unrelated business taxable income by subtracting from its gross unrelated business income deductions directly connected with the unrelated trade or business.[1056]

Under regulations, in determining unrelated business taxable income, an organization that operates multiple unrelated trades or businesses aggregates income from all such activities and subtracts from the aggregate gross income the aggregate of deductions.[1057] As a result, an organization may use a loss from one unrelated trade or business to offset gain from another, thereby reducing total unrelated business taxable income.

Organizations Subject to Tax on Unrelated Business Income

Most exempt organizations are subject to the tax on unrelated business income. Specifically, organizations subject to the unrelated business income tax generally include: (1) organizations exempt from tax under IRC section 501(a), including organizations described in IRC section 501(c) (except for U.S. instrumentalities and certain charitable trusts); (2) qualified pension, profit-sharing, and stock bonus plans described in IRC section 401(a); and (3) certain State colleges and universities.[1058]

Exclusions from Unrelated Business Taxable Income

Certain types of income are specifically exempt from unrelated business taxable income, such as dividends, interest, royalties, and certain rents,[1059] unless derived from debt-financed property or

[1054] IRC sections 511-514.
[1055] Treasury Regulation sections 1.501(c)(3)-1(e).
[1056] IRC section 512(a).
[1057] Treasury Regulation sections 1.512(a)-1(a).
[1058] IRC section 511(a)(2).
[1059] IRC section 511-514.

from certain 50-percent controlled subsidiaries.[1060] Other exemptions from UBIT are provided for activities in which substantially all the work is performed by volunteers, for income from the sale of donated goods, and for certain activities carried on for the convenience of members, students, patients, officers, or employees of a charitable organization. In addition, special UBIT provisions exempt from tax activities of trade shows and State fairs, income from bingo games, and income from the distribution of low-cost items incidental to the solicitation of charitable contributions. Organizations liable for tax on unrelated business taxable income may be liable for AMT determined after taking into account adjustments and tax preference items.

New Federal Law (IRC section 512)

Under the provision, unrelated business taxable income includes any expenses paid or incurred by a tax-exempt organization for qualified transportation fringe benefits (as defined in IRC section 132(f)), a parking facility used in connection with qualified parking (as defined in IRC section 132(f)(5)(C)), or any on-premises athletic facility (as defined in IRC section 132(j)(4)(B)), provided such amounts are not deductible under IRC section 274.

Effective Dates

The provision is effective for amounts paid or incurred after December 31, 2017.

California Law (IRC section 17201, 23732, and 24443)

California conforms, under the PITL and the CTL, to the federal rules that apply to the disallowance of certain entertainment, etc., expenses under IRC section 274, as of the "specified date" of January 1, 2015.[1061]

California also conforms, under the PITL, to the federal rules that apply to "unrelated business taxable income" under IRC section 512 as of the "specified date" of January 1, 2015, with modifications, but does not conform to the change increasing "unrelated business taxable income" by the amount of certain fringe benefit expenses for which a deduction is disallowed.

1060 IRC section 512(b)(13).
1061 R&TC section 17024.5 and 23051.5.

Impact on California Revenue

Estimated Conformity Revenue Impact of Unrelated Business Taxable Income Increased by Amount of Certain Fringe Benefit Expenses for Which Deduction is Disallowed[1062] For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
See Above Section 13304	See Above Section 13304	See Above Section 13304	See Above Section 13304

Section	Section Title
13704	Repeal of Deduction for Amounts Paid in Exchange for College Athletic Event Seating Rights

Background

In General

The IRC allows taxpayers to reduce their income tax liability by taking deductions for contributions to certain organizations, including charities, Federal, State, local, and Indian tribal governments, and certain other organizations.

To be deductible, a charitable contribution generally must meet several threshold requirements. First, the recipient of the transfer must be eligible to receive charitable contributions (*i.e.,* an organization or entity described in IRC section 170(c)). Second, the transfer must be made with gratuitous intent and without the expectation of a benefit of substantial economic value in return. Third, the transfer must be complete and generally must be a transfer of a donor's entire interest in the contributed property (*i.e.,* not a contingent or partial interest contribution). To qualify for a current year charitable deduction, payment of the contribution must be made within the taxable year.[1063] Fourth, the transfer must be of money or property—contributions of services are not deductible.[1064] Finally, the transfer must be substantiated and in the proper form.

[1062] Amounts include revenue estimates for Act sections 13304 and 13703 combined. The discussion of section 13304, Limitation on Deduction by Employers of Expenses for Fringe Benefits, will be available in a future release.
[1063] IRC section 170(a)(1).
[1064] For example, as discussed in greater detail below, the value of time spent volunteering for a charitable organization is not deductible. Incidental expenses such as mileage, supplies, or other expenses incurred while volunteering for a charitable organization, however, may be deductible.

As discussed below, special rules limit the deductibility of a taxpayer's charitable contributions in a given year to a percentage of income, and those rules, in part, turn on whether the organization receiving the contributions is a public charity or a private foundation. Other special rules determine the deductible value of contributed property for each type of property.

Contributions of Partial Interests in Property

In General

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity while retaining an interest in that property or transferring an interest in that property to a noncharity for less than full and adequate consideration.[1065] This rule of nondeductibility, often referred to as the partial interest rule, generally prohibits a charitable deduction for contributions of income interests, remainder interests, or rights to use property.

A charitable contribution deduction generally is not allowable for a contribution of a future interest in tangible personal property.[1066] For this purpose, a future interest is one "in which a donor purports to give tangible personal property to a charitable organization, but has an understanding, arrangement, agreement, etc., whether written or oral, with the charitable organization that has the effect of reserving to, or retaining in, such donor a right to the use, possession, or enjoyment of the property."[1067]

A gift of an undivided portion of a donor's entire interest in property generally is not treated as a nondeductible gift of a partial interest in property.[1068] For this purpose, an undivided portion of a donor's entire interest in property must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property and must extend over the entire term of the donor's interest in such property.[1069] A gift generally is treated as a gift of an undivided portion of a donor's entire interest in property if the donee is given the right, as a tenant in common with the donor, to possession, dominion, and control of the property for a portion of each year appropriate to its interest in such property.[1070]

Other exceptions to the partial interest rule are provided for, among other interests: (1) remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds; (2) present interests in the form of a guaranteed annuity or a fixed percentage of

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[1065] IRC sections 170(f)(3)(A) (income tax), 2055(e)(2) (estate tax), and 2522(c)(2) (gift tax).
[1066] IRC section 170(a)(3).
[1067] Treasury Regulation sections 1.170A-5(a)(4). Treasury regulations provide that section 170(a)(3), which generally denies a deduction for a contribution of a future interest in tangible personal property, has "no application in respect of a transfer of an undivided present interest in property. For example, a contribution of an undivided one-quarter interest in a painting with respect to which the donee is entitled to possession during three months of each year shall be treated as made upon the receipt by the donee of a formally executed and acknowledged deed of gift. However, the period of initial possession by the donee may not be deferred in time for more than one year." Treasury Regulation sections 1.170A-5(a)(2).
[1068] IRC section 170(f)(3)(B)(ii).
[1069] Treasury Regulation sections 1.170A-7(b)(1).
[1070] Treasury Regulation sections 1.170A-7(b)(1).

the annual value of the property; (3) a remainder interest in a personal residence or farm; and (4) qualified conservation contributions.

Qualified Conservation Contributions

Qualified conservation contributions are not subject to the partial interest rule, which generally bars deductions for charitable contributions of partial interests in property.[1071] A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property (generally, a conservation easement). Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.

Percentage Limits on Charitable Contributions

Individual Taxpayers

Charitable contributions by individual taxpayers are limited to a specified percentage of the individual's contribution base. The contribution base is the taxpayer's AGI for a taxable year, disregarding any net operating loss carryback to the year under IRC section 172.[1072] In general, more favorable (higher) percentage limits apply to contributions of cash and ordinary income property than to contributions of capital gain property. More favorable limits also generally apply to contributions to public charities (and certain operating foundations) than to contributions to nonoperating private foundations.

More specifically, the deduction for charitable contributions by an individual taxpayer of cash and property that is not appreciated to a charitable organization described in IRC section 170(b)(1)(A) (public charities, private foundations other than nonoperating private foundations, and certain governmental units) may not exceed 50 percent of the taxpayer's contribution base. Contributions of this type of property to nonoperating private foundations generally may be deducted up to the lesser of 30 percent of the taxpayer's contribution base or the excess of (i) 50 percent of the contribution base over (ii) the amount of contributions subject to the 50 percent limitation.

Contributions of appreciated capital gain property to public charities and other organizations described in IRC section 170(b)(1)(A) generally are deductible up to 30 percent of the taxpayer's

[1071] IRC sections 170(f)(3)(B)(iii) and 170(h).
[1072] IRC section 170(b)(1)(G).

contribution base (after taking into account contributions other than contributions of capital gain property). An individual may elect, however, to bring all these contributions of appreciated capital gain property for a taxable year within the 50-percent limitation category by reducing the amount of the contribution deduction by the amount of the appreciation in the capital gain property. Contributions of appreciated capital gain property to nonoperating private foundations are deductible up to the lesser of 20 percent of the taxpayer's contribution base or the excess of (i) 30 percent of the contribution base over (ii) the amount of contributions subject to the 30 percent limitation.

Finally, contributions that are for the use of (not to) the donee charity get less favorable percentage limits. Contributions of capital gain property for the use of public charities and other organizations described in IRC section 170(b)(1)(A) also are limited to 20 percent of the taxpayer's contribution base. Property contributed for the use of an organization generally has been interpreted to mean property contributed in trust for the organization.[1073] Charitable contributions of income interests (where deductible) also generally are treated as contributions for the use of the donee organization.

TABLE 3.—CHARITABLE CONTRIBUTION PERCENTAGE LIMITS FOR INDIVIDUAL TAXPAYERS[1074]

	Ordinary Income Property and Cash	Capital Gain Property to the Recipient[1075]	Capital Gain Property for the use of the Recipient
Public Charities, Private Operating Foundations, and Private Distributing Foundations	50%	30%[1076]	20%
Nonoperating Private Foundations	30%	20%	20%

Corporate Taxpayers

A corporation generally may deduct charitable contributions up to 10 percent of the corporation's taxable income for the year.[1077] For this purpose, taxable income is determined without regard to: (1) the charitable contributions deduction; (2) any net operating loss carryback to the taxable year;

[1073] *Rockefeller v. Commissioner*, 676 F.2d 35, 39 (2d Cir. 1982).
[1074] Percentages shown are the percentage of an individual's contribution base.
[1075] Capital gain property contributed to public charities, private operating foundations, or private distributing foundations will be subject to the 50-percent limitation if the donor elects to reduce the fair market value of the property by the amount that would have been long-term capital gain if the property had been sold.
[1076] Certain qualified conservation contributions to public charities (generally, conservation easements), qualify for more generous contribution limits. In general, the 30-percent limit applicable to contributions of capital gain property is increased to 100 percent if the individual making the qualified conservation contribution is a qualified farmer or rancher or to 50 percent if the individual is not a qualified farmer or rancher.
[1077] IRC section 170(b)(2)(A).

(3) deductions for dividends received; (4) deductions for dividends paid on certain preferred stock of public utilities; and (5) any capital loss carryback to the taxable year.[1078]

Carryforwards of Excess Contributions

Charitable contributions that exceed the applicable percentage limit generally may be carried forward for up to five years.[1079] In general, contributions carried over from a prior year are taken into account after contributions for the current year that are subject to the same percentage limit. Excess contributions made for the use of (rather than to) an organization generally may not be carried forward.

Qualified Conservation Contributions

Preferential percentage limits and carryforward rules apply for qualified conservation contributions.[1080] In general, the 30-percent contribution base limitation on contributions of capital gain property by individuals does not apply to qualified conservation contributions. Instead, individuals may deduct the fair market value of any qualified conservation contribution to an organization described in IRC section 170(b)(1)(A) (generally, public charities) to the extent of the excess of 50 percent of the contribution base over the amount of all other allowable charitable contributions. These contributions are not taken into account in determining the amount of other allowable charitable contributions. Individuals are allowed to carry forward any qualified conservation contributions that exceed the 50-percent limitation for up to 15 years. In the case of an individual who is a qualified farmer or rancher for the taxable year in which the contribution is made, a qualified conservation contribution is allowable up to 100 percent of the excess of the taxpayer's contribution base over the amount of all other allowable charitable contributions.

In the case of a corporation (other than a publicly traded corporation) that is a qualified farmer or rancher for the taxable year in which the contribution is made, any qualified conservation contribution is allowable up to 100 percent of the excess of the corporation's taxable income (as computed under IRC section 170(b)(2)) over the amount of all other allowable charitable contributions. Any excess may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.[1081]

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

[1078] IRC section 170(b)(2)(C).
[1079] IRC section 170(d).
[1080] IRC section 170(b)(1)(E).
[1081] IRC section 170(b)(2)(B).

Valuation of Charitable Contributions

In General

For purposes of the income tax charitable deduction, the value of property contributed to charity may be limited to the fair market value of the property, the donor's tax basis in the property, or in some cases a different amount.

Charitable contributions of cash are deductible in the amount contributed, subject to the percentage limits discussed above. In addition, a taxpayer generally may deduct the full fair market value of long-term capital gain property contributed to charity.[1082] Contributions of tangible personal property also generally are deductible at fair market value if the use by the recipient charitable organization is related to its tax-exempt purpose.

In certain other cases, however, IRC section 170(e) limits the deductible value of the contribution of appreciated property to the donor's tax basis in the property. This limitation of the property's deductible value to basis generally applies, for example, for: (1) contributions of inventory or other ordinary income or short-term capital gain property; [1083] (2) contributions of tangible personal property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose; [1084] and (3) contributions to or for the use of a private foundation (other than certain private operating foundations).[1085]

For contributions of qualified appreciated stock, the above-described rule that limits the value of property contributed to or for the use of a private nonoperating foundation to the taxpayer's basis in the property does not apply; therefore, subject to certain limits, contributions of qualified appreciated stock to a nonoperating private foundation may be deducted at fair market value.[1086] Qualified appreciated stock is stock that is capital gain property and for which (as of the date of the contribution) market quotations are readily available on an established securities market.[1087] A contribution of qualified appreciated stock (when increased by the aggregate amount of all prior such contributions by the donor of stock in the corporation) generally does not include a contribution of stock to the extent the amount of the stock contributed exceeds 10 percent (in value) of all of the outstanding stock of the corporation.[1088]

Contributions of property with a fair market value that is less than the donor's tax basis generally are deductible at the fair market value of the property.

[1082] Capital gain property means any capital asset or property used in the taxpayer's trade or business, the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. IRC section 170(e)(1)(A).
[1083] IRC section 170(e). Special rules, discussed below, apply for certain contributions of inventory and other property.
[1084] IRC section 170(e)(1)(B)(i)(I).
[1085] IRC section 170(e)(1)(B)(ii). Certain contributions of patents or other intellectual property also generally are limited to the donor's basis in the property. IRC section 170(e)(1)(B)(iii). However, a special rule permits additional charitable deductions beyond the donor's tax basis in certain situations.
[1086] IRC section 170(e)(5).
[1087] IRC section 170(e)(5)(B).
[1088] IRC section 170(e)(5)(C).

Enhanced Deduction Rules for Certain Contributions of Inventory and Other Property

Although most charitable contributions of property are valued at fair market value or the donor's tax basis in the property, certain statutorily described contributions of appreciated inventory and other property qualify for an enhanced deduction valuation that exceeds the donor's tax basis in the property, but which is less than the fair market value of the property.

As discussed above, a taxpayer's deduction for charitable contributions of inventory property generally is limited to the taxpayer's basis (typically, cost) in the inventory, or if less, the fair market value of the property. For certain contributions of inventory, however, C corporations (but not other taxpayers) may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one-half of fair market value in excess of basis) or (2) two times basis.[1089] To be eligible for the enhanced deduction value, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in IRC section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements.[1090] Contributions to organizations that are not described in IRC section 501(c)(3), such as governmental entities, do not qualify for this enhanced deduction.
To use the enhanced deduction provision, the taxpayer must establish that the fair market value of the donated item exceeds basis.

A taxpayer engaged in a trade or business, whether or not a C corporation, is eligible to claim the enhanced deduction for certain donations of food inventory.[1091]

Selected Statutory Rules for Specific Types of Contributions

Special statutory rules limit the deductible value (and impose enhanced reporting obligations on donors) of charitable contributions of certain types of property, including vehicles, intellectual property, and clothing and household items. Each of these rules was enacted in response to concerns that some taxpayers did not accurately report—and in many instances overstated—the value of the property for purposes of claiming a charitable deduction.

Vehicle Donations.—Under present law, the amount of deduction for charitable contributions of vehicles (generally including automobiles, boats, and airplanes for which the claimed value exceeds $500 and excluding inventory property) depends upon the use of the vehicle by the donee organization. If the donee organization sells the vehicle without any significant intervening use or material improvement of such vehicle by the organization, the amount of the deduction

[1089] IRC section 170(e)(3).
[1090] IRC section 170(e)(3)(A)(i)-(iii).
[1091] IRC section 170(e)(3)(C).

may not exceed the gross proceeds received from the sale. In other situations, a fair market value deduction may be allowed.

Patents and Other Intellectual Property.—If a taxpayer contributes a patent or other intellectual property (other than certain copyrights or inventory) [1092] to a charitable organization, the taxpayer's initial charitable deduction is limited to the lesser of the taxpayer's basis in the contributed property or the fair market value of the property.[1093] In addition, the taxpayer generally is permitted to deduct, as a charitable contribution, certain additional amounts in the year of contribution or in subsequent taxable years based on a specified percentage of the qualified donee income received or accrued by the charitable donee with respect to the contributed intellectual property. For this purpose, qualified donee income includes net income received or accrued by the donee that properly is allocable to the intellectual property itself (as opposed to the activity in which the intellectual property is used).[1094]

Clothing and Household Items.—Charitable contributions of clothing and household items generally are subject to the charitable deduction rules applicable to tangible personal property. If such contributed property is appreciated property in the hands of the taxpayer, and is not used to further the donee's exempt purpose, the deduction is limited to basis. In most situations, however, clothing and household items have a fair market value that is less than the taxpayer's basis in the property. Because property with a fair market value less than basis generally is deductible at the property's fair market value, taxpayers generally may deduct only the fair market value of most contributions of clothing or household items, regardless of whether the property is used for exempt or unrelated purposes by the donee organization. Furthermore, a special rule generally provides that no deduction is allowed for a charitable contribution of clothing or a household item unless the item is in good used or better condition. The Secretary is authorized to deny by regulation a deduction for any contribution of clothing or a household item that has minimal monetary value, such as used socks and used undergarments. Notwithstanding the general rule, a charitable contribution of clothing or household items not in good used or better condition with a claimed value of more than $500 may be deducted if the taxpayer includes with the taxpayer's return a qualified appraisal with respect to the property.[1095] Household items include furniture, furnishings, electronics, appliances, linens, and other similar items. Food, paintings, antiques, and other objects of art, jewelry and gems, and certain collections are excluded from the special rules described in the preceding paragraph.[1096]

[1092] Under present and prior law, certain copyrights are not considered capital assets, such that the charitable deduction for such copyrights generally is limited to the taxpayer's basis. See IRC section 1221(a)(3), 1231(b)(1)(C).

[1093] IRC section 170(e)(1)(B)(iii).

[1094] The present-law rules allowing additional charitable deductions for qualified donee income were enacted as part of the American Jobs Creation Act of 2004, and are effective for contributions made after June 3, 2004. For a more detailed description of these rules, see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress* (JCS-5-05), May 2005, pp. 457-461.

[1095] As is discussed above, the charitable contribution substantiation rules generally require a qualified appraisal where the claimed value of a contribution is more than $5,000.

[1096] The special rules concerning the deductibility of clothing and household items were enacted as part of the Pension Protection Act of 2006, P.L. 109-280 (August 17, 2006), and are effective for contributions made after August 17, 2006. For a more detailed description of these rules, see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 109th Congress* (JCS-1-07), January 17, 2007, pp. 597-600.

College athletic seating rights.—In general, where a taxpayer receives or expects to receive a substantial return benefit for a payment to charity, the payment is not deductible as a charitable contribution. However, special rules apply to certain payments to institutions of higher education in exchange for which the payor receives the right to purchase tickets or seating at an athletic event. Specifically, the payor may treat 80 percent of a payment as a charitable contribution where: (1) the amount is paid to or for the benefit of an institution of higher education (as defined in IRC section 3304(f)) described in IRC section (b)(1)(A)(ii) (generally, a school with a regular faculty and curriculum and meeting certain other requirements), and (2) such amount would be allowable as a charitable deduction but for the fact that the taxpayer receives (directly or indirectly) as a result of the payment the right to purchase tickets for seating at an athletic event in an athletic stadium of such institution.[1097]

Use of a Vehicle When Volunteering for a Charity

Unreimbursed out-of-pocket expenditures made incident to providing donated services to a qualified charitable organization—such as out-of-pocket transportation expenses necessarily incurred in performing donated services—may qualify as a charitable contribution.[1098] No charitable contribution deduction is allowed for traveling expenses (including expenses for meals and lodging) while away from home, whether paid directly or by reimbursement, unless there is no significant element of personal pleasure, recreation, or vacation in such travel.[1099]

In determining the amount treated as a charitable contribution where a taxpayer operates a vehicle in providing donated services to a charity, the taxpayer either may track and deduct actual out-of-pocket expenditures or, in the case of a passenger automobile, may use the charitable standard mileage rate. The charitable standard mileage rate is set by statute at 14 cents per mile.[1100] The taxpayer may also deduct (under either computation method), any parking fees and tolls incurred in rendering the services, but may not deduct any amount (regardless of the computation method used) for general repair or maintenance expenses, depreciation, insurance, registration fees, etc. Regardless of the computation method used, the taxpayer must keep reliable written records of expenses incurred. For example, where a taxpayer uses the charitable standard mileage rate to determine a deduction, the IRS has stated that the taxpayer generally must maintain records of miles driven, time, place (or use), and purpose of the mileage. If the charitable standard mileage rate is not used to determine the deduction, the taxpayer generally must maintain reliable written records of actual expenses incurred.[1101]

[1097] IRC section 170(l).
[1098] Treasury Regulation sections 1.170A-1(g).
[1099] IRC section 170(j).
[1100] IRC section 170(i).
[1101] In lieu of actual operating expenses, an optional standard mileage rate may be used in computing deductible transportation expenses for medical purposes (IRC section 213) or for work-related moving (IRC section 217). The standard mileage rates for medical and moving purposes generally cover only out-of-pocket operating expenses (including gasoline and oil) directly related to the use of the automobile. Such rates do not include costs that are not deductible for medical or moving purposes, such as general maintenance expenses, depreciation, insurance, and registration fees. The medical and moving standard mileage rates are determined by the IRS and updated periodically. For expenses paid or incurred on or after January 1, 2017, the rate for both such purposes is 17 cents per mile. IRS Notice 2016-79.

Substantiation and Other Formal Requirements

In General

A donor who claims a deduction for a charitable contribution must maintain reliable written records regarding the contribution, regardless of the value or amount of such contribution.[1102] In the case of a charitable contribution of money, regardless of the amount, applicable recordkeeping requirements are satisfied only if the donor maintains as a record of the contribution a bank record or a written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution. In such cases, the recordkeeping requirements may not be satisfied by maintaining other written records.

No charitable contribution deduction is allowed for a separate contribution of $250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.[1103]

In addition, any charity receiving a contribution exceeding $75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a “quid pro quo” contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services is deductible as a charitable contribution.[1104]

If the total charitable deduction claimed for noncash property is more than $500, the taxpayer must attach a completed Form 8283 (Noncash Charitable Contributions) to the taxpayer's return or the deduction is not allowed.[1105] In general, taxpayers are required to obtain a qualified appraisal for donated property with a value of more than $5,000, and to attach an appraisal summary to the tax return.

Exception for Certain Contributions Reported by the Donee Organization

IRC subsection 170(f)(8)(D) provides an exception to the contemporaneous written acknowledgment requirement described above. Under the exception, a contemporaneous written acknowledgment is not required if the donee organization files a return, on such form and in accordance with such regulations as the Secretary may prescribe, that includes the same content. “[T]he section 170(f)(8)(D) exception is not available unless and until the Treasury Department

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[1102] IRC section 170(f)(17).
[1103] Such acknowledgement must include the amount of cash and a description (but not value) of any property other than cash contributed, whether the donee provided any goods or services in consideration for the contribution, and a good faith estimate of the value of any such goods or services. IRC section 170(f)(8).
[1104] IRC section 6115.
[1105] IRC section 170(f)(11).

and the IRS issue final regulations prescribing the method by which donee reporting may be accomplished."[1106] No such final regulations have been issued.[1107]

New Federal Law (IRC section 170)

The provision amends IRC section 170(l) to provide that no charitable deduction shall be allowed for any amount described in paragraph 170(l)(2), generally a payment to an institution of higher education in exchange for which the payor receives the right to purchase tickets or seating at an athletic event, as described in greater detail above.

Effective Dates

The provisions is effective for contributions made in taxable years beginning after December 31, 2017.

California Law (R&TC sections 17201, 24357 – 24359.1)

California conforms, under the PITL, to the federal charitable contribution rules under IRC section 170 as of the "specified date" of January 1, 2015,[1108] with modifications, but does not conform to the repeal of the deduction for amounts paid in exchange for college athletic event seating rights.

Under the CTL, California does not conform to IRC section 170, but instead has stand-alone law that is generally similar to federal law allowing corporations a deduction for charitable contributions.[1109] R&TC section 24357.10 provides that if an amount is paid to or for the benefit of a school or university and such amount would be deductible as a charitable contribution except for the fact that the taxpayer is given the right to buy tickets for seating at an athletic event in the institution's stadium, 80 percent of the contribution will be allowed as charitable contribution. The deductible amount does not include the portion of the contribution representing the actual cost of the tickets.

As a result, California does not conform to the repeal of the deduction for amounts paid in exchange for college athletic event seating rights.

[1106] See IRS, Notice of Proposed Rulemaking, Substantiation Requirement for Certain Contributions, REG-138344-13 (October 13, 2015), I.R.B. 2015-41 (preamble).
[1107] In October 2015, the IRS issued proposed regulations that, if finalized, would have implemented the IRC section 170(f)(8)(D) exception to the contemporaneous written acknowledgment requirement. The proposed regulations provided that a return filed by a donee organization under IRC section 170(f)(8)(D) must include, in addition to the information generally required on a contemporaneous written acknowledgment: (1) the name and address of the donee organization; (2) the name and address of the donor; and (3) the taxpayer identification number of the donor. In addition, the return must be filed with the IRS (with a copy provided to the donor) on or before February 28 of the year following the calendar year in which the contribution was made. Under the proposed regulations, donee reporting would have been optional and would have been available solely at the discretion of the donee organization. The proposed regulations were withdrawn in January 2016. See Prop. Treas. Reg. sec 1.170A-13(f)(18).
[1108] R&TC section 17024.5.
[1109] R&TC sections 24357 – 24359.1.

Impact on California Revenue

Estimated Conformity Revenue Impact of Repeal of Deduction for Amounts Paid in Exchange for College Athletic Event Seating Rights For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	$5,100,000	$2,700,000	$2,700,000

Section	Section Title
13705	Repeal of Substantiation Exception in Case of Contributions Reported by Donee

Background

In General

The IRC allows taxpayers to reduce their income tax liability by taking deductions for contributions to certain organizations, including charities, Federal, State, local, and Indian tribal governments, and certain other organizations.

To be deductible, a charitable contribution generally must meet several threshold requirements. First, the recipient of the transfer must be eligible to receive charitable contributions (*i.e.,* an organization or entity described in IRC section 170(c)). Second, the transfer must be made with gratuitous intent and without the expectation of a benefit of substantial economic value in return. Third, the transfer must be complete and generally must be a transfer of a donor's entire interest in the contributed property (*i.e.,* not a contingent or partial interest contribution). To qualify for a current year charitable deduction, payment of the contribution must be made within the taxable year.[1110] Fourth, the transfer must be of money or property—contributions of services are not deductible.[1111] Finally, the transfer must be substantiated and in the proper form.

As discussed below, special rules limit the deductibility of a taxpayer's charitable contributions in a given year to a percentage of income, and those rules, in part, turn on whether the organization receiving the contributions is a public charity or a private foundation. Other special rules determine the deductible value of contributed property for each type of property.

[1110] IRC section 170(a)(1).
[1111] For example, as discussed in greater detail below, the value of time spent volunteering for a charitable organization is not deductible. Incidental expenses such as mileage, supplies, or other expenses incurred while volunteering for a charitable organization, however, may be deductible.

Contributions of Partial Interests in Property

In General

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity while retaining an interest in that property or transferring an interest in that property to a noncharity for less than full and adequate consideration.[1112] This rule of nondeductibility, often referred to as the partial interest rule, generally prohibits a charitable deduction for contributions of income interests, remainder interests, or rights to use property.

A charitable contribution deduction generally is not allowable for a contribution of a future interest in tangible personal property.[1113] For this purpose, a future interest is one "in which a donor purports to give tangible personal property to a charitable organization, but has an understanding, arrangement, agreement, etc., whether written or oral, with the charitable organization that has the effect of reserving to, or retaining in, such donor a right to the use, possession, or enjoyment of the property."[1114]

A gift of an undivided portion of a donor's entire interest in property generally is not treated as a nondeductible gift of a partial interest in property.[1115] For this purpose, an undivided portion of a donor's entire interest in property must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property and must extend over the entire term of the donor's interest in such property.[1116] A gift generally is treated as a gift of an undivided portion of a donor's entire interest in property if the donee is given the right, as a tenant in common with the donor, to possession, dominion, and control of the property for a portion of each year appropriate to its interest in such property.[1117]

Other exceptions to the partial interest rule are provided for, among other interests: (1) remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds; (2) present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property; (3) a remainder interest in a personal residence or farm; and (4) qualified conservation contributions.

[1112] IRC sections 170(f)(3)(A) (income tax), 2055(e)(2) (estate tax), and 2522(c)(2) (gift tax).
[1113] IRC section 170(a)(3).
[1114] Treasury Regulation sections 1.170A-5(a)(4). Treasury regulations provide that IRC section 170(a)(3), which generally denies a deduction for a contribution of a future interest in tangible personal property, has ''no application in respect of a transfer of an undivided present interest in property. For example, a contribution of an undivided one-quarter interest in a painting with respect to which the donee is entitled to possession during three months of each year shall be treated as made upon the receipt by the donee of a formally executed and acknowledged deed of gift. However, the period of initial possession by the donee may not be deferred in time for more than one year." Treasury Regulation sections 1.170A-5(a)(2).
[1115] IRC section 170(f)(3)(B)(ii).
[1116] Treasury Regulation sections 1.170A-7(b)(1).
[1117] Treasury Regulation sections 1.170A-7(b)(1).

Qualified Conservation Contributions

Qualified conservation contributions are not subject to the partial interest rule, which generally bars deductions for charitable contributions of partial interests in property.[1118] A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real property (generally, a conservation easement). Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.

Percentage Limits on Charitable Contributions

Individual Taxpayers

Charitable contributions by individual taxpayers are limited to a specified percentage of the individual's contribution base. The contribution base is the taxpayer's AGI for a taxable year, disregarding any net operating loss carryback to the year under IRC section 172.[1119] In general, more favorable (higher) percentage limits apply to contributions of cash and ordinary income property than to contributions of capital gain property. More favorable limits also generally apply to contributions to public charities (and certain operating foundations) than to contributions to nonoperating private foundations.

More specifically, the deduction for charitable contributions by an individual taxpayer of cash and property that is not appreciated to a charitable organization described in IRC section 170(b)(1)(A) (public charities, private foundations other than nonoperating private foundations, and certain governmental units) may not exceed 50 percent of the taxpayer's contribution base. Contributions of this type of property to nonoperating private foundations generally may be deducted up to the lesser of 30 percent of the taxpayer's contribution base or the excess of (i) 50 percent of the contribution base over (ii) the amount of contributions subject to the 50-percent limitation.

Contributions of appreciated capital gain property to public charities and other organizations described in IRC section 170(b)(1)(A) generally are deductible up to 30 percent of the taxpayer's contribution base (after taking into account contributions other than contributions of capital gain property). An individual may elect, however, to bring all these contributions of appreciated capital gain property for a taxable year within the 50-percent limitation category by reducing the amount

[1118] IRC sections 170(f)(3)(B)(iii) and 170(h).
[1119] IRC section 170(b)(1)(G).

of the contribution deduction by the amount of the appreciation in the capital gain property. Contributions of appreciated capital gain property to nonoperating private foundations are deductible up to the lesser of 20 percent of the taxpayer's contribution base or the excess of (i) 30 percent of the contribution base over (ii) the amount of contributions subject to the 30-percent limitation.

Finally, contributions that are for the use of (not to) the donee charity get less favorable percentage limits. Contributions of capital gain property for the use of public charities and other organizations described in IRC section 170(b)(1)(A) also are limited to 20 percent of the taxpayer's contribution base. Property contributed for the use of an organization generally has been interpreted to mean property contributed in trust for the organization.[1120] Charitable contributions of income interests (where deductible) also generally are treated as contributions for the use of the donee organization.

TABLE 3.—CHARITABLE CONTRIBUTION PERCENTAGE LIMITS FOR INDIVIDUAL TAXPAYERS[1121]

Ordinary Income Property and Cash		Capital Gain Property to the Recipient[1122]	Capital Gain Property for the use of the Recipient
Public Charities, Private Operating Foundations, and Private Distributing Foundations	50%	30%[1123]	20%
Nonoperating Private Foundations	30%	20%	20%

Corporate Taxpayers

A corporation generally may deduct charitable contributions up to 10 percent of the corporation's taxable income for the year.[1124] For this purpose, taxable income is determined without regard to: (1) the charitable contributions deduction; (2) any net operating loss carryback to the taxable year; (3) deductions for dividends received; (4) deductions for dividends paid on certain preferred stock of public utilities; and (5) any capital loss carryback to the taxable year.[1125]

[1120] *Rockefeller v. Commissioner*, 676 F.2d 35, 39 (2d Cir. 1982).
[1121] Percentages shown are the percentage of an individual's contribution base.
[1122] Capital gain property contributed to public charities, private operating foundations, or private distributing foundations will be subject to the 50-percent limitation if the donor elects to reduce the fair market value of the property by the amount that would have been long-term capital gain if the property had been sold.
[1123] Certain qualified conservation contributions to public charities (generally, conservation easements), qualify for more generous contribution limits. In general, the 30-percent limit applicable to contributions of capital gain property is increased to 100 percent if the individual making the qualified conservation contribution is a qualified farmer or rancher or to 50 percent if the individual is not a qualified farmer or rancher.
[1124] IRC section 170(b)(2)(A).
[1125] IRC section 170(b)(2)(C).

Carryforwards of Excess Contributions

Charitable contributions that exceed the applicable percentage limit generally may be carried forward for up to five years.[1126] In general, contributions carried over from a prior year are taken into account after contributions for the current year that are subject to the same percentage limit. Excess contributions made for the use of (rather than to) an organization generally may not be carried forward.

Qualified Conservation Contributions

Preferential percentage limits and carryforward rules apply for qualified conservation contributions.[1127] In general, the 30-percent contribution base limitation on contributions of capital gain property by individuals does not apply to qualified conservation contributions. Instead, individuals may deduct the fair market value of any qualified conservation contribution to an organization described in IRC section 170(b)(1)(A) (generally, public charities) to the extent of the excess of 50 percent of the contribution base over the amount of all other allowable charitable contributions. These contributions are not taken into account in determining the amount of other allowable charitable contributions. Individuals are allowed to carry forward any qualified conservation contributions that exceed the 50-percent limitation for up to 15 years. In the case of an individual who is a qualified farmer or rancher for the taxable year in which the contribution is made, a qualified conservation contribution is allowable up to 100 percent of the excess of the taxpayer's contribution base over the amount of all other allowable charitable contributions.

In the case of a corporation (other than a publicly traded corporation) that is a qualified farmer or rancher for the taxable year in which the contribution is made, any qualified conservation contribution is allowable up to 100 percent of the excess of the corporation's taxable income (as computed under IRC section 170(b)(2)) over the amount of all other allowable charitable contributions. Any excess may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.[1128]

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

Valuation of Charitable Contributions

In General

For purposes of the income tax charitable deduction, the value of property contributed to charity may be limited to the fair market value of the property, the donor's tax basis in the property, or in some cases a different amount.

[1126] IRC section 170(d).
[1127] IRC section 170(b)(1)(E).
[1128] IRC section 170(b)(2)(B).

Charitable contributions of cash are deductible in the amount contributed, subject to the percentage limits discussed above. In addition, a taxpayer generally may deduct the full fair market value of long-term capital gain property contributed to charity.[1129] Contributions of tangible personal property also generally are deductible at fair market value if the use by the recipient charitable organization is related to its tax-exempt purpose.

In certain other cases, however, IRC section 170(e) limits the deductible value of the contribution of appreciated property to the donor's tax basis in the property. This limitation of the property's deductible value to basis generally applies, for example, for: (1) contributions of inventory or other ordinary income or short-term capital gain property;[1130] (2) contributions of tangible personal property if the use by the recipient charitable organization is unrelated to the organization's tax-exempt purpose;[1131] and (3) contributions to or for the use of a private foundation (other than certain private operating foundations).[1132]

For contributions of qualified appreciated stock, the above-described rule that limits the value of property contributed to or for the use of a private nonoperating foundation to the taxpayer's basis in the property does not apply; therefore, subject to certain limits, contributions of qualified appreciated stock to a nonoperating private foundation may be deducted at fair market value.[1133] Qualified appreciated stock is stock that is capital gain property and for which (as of the date of the contribution) market quotations are readily available on an established securities market.[1134] A contribution of qualified appreciated stock (when increased by the aggregate amount of all prior such contributions by the donor of stock in the corporation) generally does not include a contribution of stock to the extent the amount of the stock contributed exceeds 10 percent (in value) of all of the outstanding stock of the corporation.[1135]

Contributions of property with a fair market value that is less than the donor's tax basis generally are deductible at the fair market value of the property.

Enhanced Deduction Rules for Certain Contributions of Inventory and Other Property

Although most charitable contributions of property are valued at fair market value or the donor's tax basis in the property, certain statutorily described contributions of appreciated inventory and other property qualify for an enhanced deduction valuation that exceeds the donor's tax basis in the property, but which is less than the fair market value of the property.

[1129]Capital gain property means any capital asset or property used in the taxpayer's trade or business, the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. IRC section 170(e)(1)(A).
[1130] IRC section 170(e). Special rules, discussed below, apply for certain contributions of inventory and other property.
[1131] IRC section 170(e)(1)(B)(i)(I).
[1132] IRC section 170(e)(1)(B)(ii). Certain contributions of patents or other intellectual property also generally are limited to the donor's basis in the property. IRC section 170(e)(1)(B)(iii). However, a special rule permits additional charitable deductions beyond the donor's tax basis in certain situations.
[1133] IRC section 170(e)(5).
[1134] IRC section 170(e)(5)(B).
[1135] IRC section 170(e)(5)(C).

As discussed above, a taxpayer's deduction for charitable contributions of inventory property generally is limited to the taxpayer's basis (typically, cost) in the inventory, or if less, the fair market value of the property. For certain contributions of inventory, however, C corporations (but not other taxpayers) may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one-half of fair market value in excess of basis) or (2) two times basis.[1136] To be eligible for the enhanced deduction value, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in IRC section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements.[1137] Contributions to organizations that are not described in IRC section 501(c)(3), such as governmental entities, do not qualify for this enhanced deduction.

To use the enhanced deduction provision, the taxpayer must establish that the fair market value of the donated item exceeds basis.

A taxpayer engaged in a trade or business, whether or not a C corporation, is eligible to claim the enhanced deduction for certain donations of food inventory.[1138]

Selected Statutory Rules for Specific Types of Contributions

Special statutory rules limit the deductible value (and impose enhanced reporting obligations on donors) of charitable contributions of certain types of property, including vehicles, intellectual property, and clothing and household items. Each of these rules was enacted in response to concerns that some taxpayers did not accurately report—and in many instances overstated—the value of the property for purposes of claiming a charitable deduction.

Vehicle Donations.—Under present law, the amount of deduction for charitable contributions of vehicles (generally including automobiles, boats, and airplanes for which the claimed value exceeds $500 and excluding inventory property) depends upon the use of the vehicle by the donee organization. If the donee organization sells the vehicle without any significant intervening use or material improvement of such vehicle by the organization, the amount of the deduction may not exceed the gross proceeds received from the sale. In other situations, a fair market value deduction may be allowed.

Patents and Other Intellectual Property.—If a taxpayer contributes a patent or other intellectual property (other than certain copyrights or inventory) [1139] to a charitable organization, the taxpayer's initial charitable deduction is limited to the lesser of the taxpayer's basis in the contributed property or the fair market value of the property.[1140] In addition, the taxpayer

[1136] IRC section 170(e)(3).
[1137] IRC section 170(e)(3)(A)(i)-(iii).
[1138] IRC section 170(e)(3)(C).
[1139] Under present and prior law, certain copyrights are not considered capital assets, such that the charitable deduction for such copyrights generally is limited to the taxpayer's basis. See IRC section 1221(a)(3), 1231(b)(1)(C).
[1140] IRC section 170(e)(1)(B)(iii).

generally is permitted to deduct, as a charitable contribution, certain additional amounts in the year of contribution or in subsequent taxable years based on a specified percentage of the qualified donee income received or accrued by the charitable donee with respect to the contributed intellectual property. For this purpose, qualified donee income includes net income received or accrued by the donee that properly is allocable to the intellectual property itself (as opposed to the activity in which the intellectual property is used).[1141]

Clothing and Household Items.—Charitable contributions of clothing and household items generally are subject to the charitable deduction rules applicable to tangible personal property. If such contributed property is appreciated property in the hands of the taxpayer, and is not used to further the donee's exempt purpose, the deduction is limited to basis. In most situations, however, clothing and household items have a fair market value that is less than the taxpayer's basis in the property. Because property with a fair market value less than basis generally is deductible at the property's fair market value, taxpayers generally may deduct only the fair market value of most contributions of clothing or household items, regardless of whether the property is used for exempt or unrelated purposes by the donee organization. Furthermore, a special rule generally provides that no deduction is allowed for a charitable contribution of clothing or a household item unless the item is in good used or better condition. The Secretary is authorized to deny by regulation a deduction for any contribution of clothing or a household item that has minimal monetary value, such as used socks and used undergarments. Notwithstanding the general rule, a charitable contribution of clothing or household items not in good used or better condition with a claimed value of more than $500 may be deducted if the taxpayer includes with the taxpayer's return a qualified appraisal with respect to the property.[1142] Household items include furniture, furnishings, electronics, appliances, linens, and other similar items. Food, paintings, antiques, and other objects of art, jewelry and gems, and certain collections are excluded from the special rules described in the preceding paragraph.[1143]

Use of a Vehicle When Volunteering for a Charity

Unreimbursed out-of-pocket expenditures made incident to providing donated services to a qualified charitable organization—such as out-of-pocket transportation expenses necessarily incurred in performing donated services—may qualify as a charitable contribution.[1144] No charitable contribution deduction is allowed for traveling expenses (including expenses for meals and lodging) while away from home, whether paid directly or by reimbursement, unless there is no significant element of personal pleasure, recreation, or vacation in such travel.[1145]

[1141] The present-law rules allowing additional charitable deductions for qualified donee income were enacted as part of the American Jobs Creation Act of 2004, and are effective for contributions made after June 3, 2004. For a more detailed description of these rules, see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 108th Congress* (JCS-5-05), May 2005, pp. 457-461.

[1142] As is discussed above, the charitable contribution substantiation rules generally require a qualified appraisal where the claimed value of a contribution is more than $5,000.

[1143] The special rules concerning the deductibility of clothing and household items were enacted as part of the Pension Protection Act of 2006, P.L. 109-280 (August 17, 2006), and are effective for contributions made after August 17, 2006. For a more detailed description of these rules, see Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 109th Congress* (JCS-1-07), January 17, 2007, pp. 597-600.

[1144] Treasury Regulation sections 1.170A-1(g).

[1145] IRC section 170(j).

In determining the amount treated as a charitable contribution where a taxpayer operates a vehicle in providing donated services to a charity, the taxpayer either may track and deduct actual out-of-pocket expenditures or, in the case of a passenger automobile, may use the charitable standard mileage rate. The charitable standard mileage rate is set by statute at 14 cents per mile.[1146] The taxpayer may also deduct (under either computation method), any parking fees and tolls incurred in rendering the services, but may not deduct any amount (regardless of the computation method used) for general repair or maintenance expenses, depreciation, insurance, registration fees, etc. Regardless of the computation method used, the taxpayer must keep reliable written records of expenses incurred. For example, where a taxpayer uses the charitable standard mileage rate to determine a deduction, the IRS has stated that the taxpayer generally must maintain records of miles driven, time, place (or use), and purpose of the mileage. If the charitable standard mileage rate is not used to determine the deduction, the taxpayer generally must maintain reliable written records of actual expenses incurred.[1147]

Substantiation and Other Formal Requirements

In General

A donor who claims a deduction for a charitable contribution must maintain reliable written records regarding the contribution, regardless of the value or amount of such contribution.[1148] In the case of a charitable contribution of money, regardless of the amount, applicable recordkeeping requirements are satisfied only if the donor maintains as a record of the contribution a bank record or a written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution. In such cases, the recordkeeping requirements may not be satisfied by maintaining other written records.

No charitable contribution deduction is allowed for a separate contribution of $250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.[1149]

In addition, any charity receiving a contribution exceeding $75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a "quid pro quo" contribution) is

[1146] IRC section 170(i).
[1147] In lieu of actual operating expenses, an optional standard mileage rate may be used in computing deductible transportation expenses for medical purposes (IRC section 213) or for work-related moving (IRC section 217). The standard mileage rates for medical and moving purposes generally cover only out-of-pocket operating expenses (including gasoline and oil) directly related to the use of the automobile. Such rates do not include costs that are not deductible for medical or moving purposes, such as general maintenance expenses, depreciation, insurance, and registration fees. The medical and moving standard mileage rates are determined by the IRS and updated periodically. For expenses paid or incurred on or after January 1, 2017, the rate for both such purposes is 17 cents per mile. IRS Notice 2016-79.
[1148] IRC section 170(f)(17).
[1149] Such acknowledgement must include the amount of cash and a description (but not value) of any property other than cash contributed, whether the donee provided any goods or services in consideration for the contribution, and a good faith estimate of the value of any such goods or services. IRC section 170(f)(8).

required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services is deductible as a charitable contribution.[1150]

If the total charitable deduction claimed for noncash property is more than $500, the taxpayer must attach a completed Form 8283 (Noncash Charitable Contributions) to the taxpayer's return or the deduction is not allowed.[1151] In general, taxpayers are required to obtain a qualified appraisal for donated property with a value of more than $5,000, and to attach an appraisal summary to the tax return.

Exception for Certain Contributions Reported by the Donee Organization

IRC subsection 170(f)(8)(D) provides an exception to the contemporaneous written acknowledgment requirement described above. Under the exception, a contemporaneous written acknowledgment is not required if the donee organization files a return, on such form and in accordance with such regulations as the Secretary may prescribe, that includes the same content. "[T]he section 170(f)(8)(D) exception is not available unless and until the Treasury Department and the IRS issue final regulations prescribing the method by which donee reporting may be accomplished."[1152] No such final regulations have been issued.[1153]

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

The provision repeals the section 170(f)(8)(D) exception to the contemporaneous written acknowledgment requirement.

<u>Effective Dates</u>

The provision is effective for contributions made in taxable years beginning after December 31, 2016.

<u>California Law (R&TC sections 17201, 17275.5, and 24357)</u>

California conforms under the PITL, to the federal charitable contribution rules under IRC section 170 as of the "specified date" of January 1, 2015,[1154] with modifications. Additionally, California

[1150] IRC section 6115.
[1151] IRC section 170(f)(11).
[1152] See IRS, Notice of Proposed Rulemaking, Substantiation Requirement for Certain Contributions, REG-138344-13 (October 13, 2015), I.R.B. 2015-41 (preamble).
[1153] In October 2015, the IRS issued proposed regulations that, if finalized, would have implemented the IRC section 170(f)(8)(D) exception to the contemporaneous written acknowledgment requirement. The proposed regulations provided that a return filed by a donee organization under IRC section 170(f)(8)(D) must include, in addition to the information generally required on a contemporaneous written acknowledgment: (1) the name and address of the donee organization; (2) the name and address of the donor; and (3) the taxpayer identification number of the donor. In addition, the return must be filed with the IRS (with a copy provided to the donor) on or before February 28 of the year following the calendar year in which the contribution was made. Under the proposed regulations, donee reporting would have been optional and would have been available solely at the discretion of the donee organization. The proposed regulations were withdrawn in January 2016. See Prop. Treas. Reg. sec 1.170A-13(f)(18).
[1154] R&TC section 17024.5.

law[1155] provides that upon a showing that the federal substantiation requirements are met for a particular contribution, a deduction will not be denied for California purposes.

As a result, California does not conform to the repeal of the exception to the contemporaneous written acknowledgment requirement.

Under the CTL, California does not conform to IRC section 170, but instead has stand-alone law that is generally similar to federal law allowing corporations a deduction for charitable contributions.[1156] However, R&TC section 24357 specifically conforms to paragraph (8) of subdivision (f) of IRC section 170, relating to the contemporaneous written acknowledgment requirement and to the exception, as of the "specified date" of January 1, 2015.[1157]

As a result, California does not conform to the repeal of the exception to the contemporaneous written acknowledgment requirement.

<u>Impact on California Revenue</u>

Estimated Conformity Revenue Impact of Repeal of Substantiation Exception in Case of Contributions Reported by Donee For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	Negligible	Negligible	Negligible

[1155] R&TC section 17275.5.
[1156] R&TC sections 24357 – 24359.1.
[1157] R&TC section 23051.5.

Part IX—Other Provisions

Subpart A—Craft Beverage Modernization and Tax Reform

Section	Section Title
13801	Production Period for Beer, Wine, and Distilled Spirits

Background

In General

The uniform capitalization (UNICAP) rules, which were enacted as part of the Tax Reform Act of 1986,[1158] require certain direct and indirect costs allocable to real or tangible personal property produced by the taxpayer to be included in either inventory or capitalized into the basis of such property, as applicable.[1159] For real or personal property acquired by the taxpayer for resale, IRC section 263A generally requires certain direct and indirect costs allocable to such property to be included in inventory.

In the case of interest expense, the UNICAP rules apply only to interest paid or incurred during the property's production period[1160] and that is allocable to property produced by the taxpayer or acquired for resale which (1) is either real property or property with a class life of at least 20 years, (2) has an estimated production period exceeding two years, or (3) has an estimated production period exceeding one year and a cost exceeding $1,000,000.[1161] The production period with respect to any property is the period beginning on the date on which production of the property begins, and ending on the date on which the property is ready to be placed in service or held for sale.[1162] I n the case of property that is customarily aged (e.g., tobacco, wine, and whiskey) before it is sold, the production period includes the aging period.[1163]

Exceptions from UNICAP

IRC section 263A provides a number of exceptions to the general capitalization requirements. One such exception exists for certain small taxpayers who acquire property for resale and have $10 million or less of average annual gross receipts for the preceding three-taxable year period;[1164] such taxpayers are not required to include additional IRC section 263A costs in inventory.

[1158] IRC section 803(a) of Pub. L. No. 99-514 (1986).
[1159] IRC section 263A.
[1160] See Treasury Regulation sections 1.263A-12.
[1161] IRC section 263A(f).
[1162] IRC section 263A(f)(4)(B).
[1163] See Treasury Regulation sections 1.263A-12(d)(1). See also TAM 9327007 (Mar. 31, 1993) (holding that producers of wine must include the time that wine ages in bottles as part of the production period, which concludes when the wine vintage is officially released to the distribution chain).
[1164] IRC section 263A(b)(2)(B). No statutory exception is available for small taxpayers who produce property subject to IRC section 263A. However, a *de minimis* rule under Treasury regulations treats producers that use the simplified production method and incur total indirect costs of $200,000 or less in a taxable year as having no additional indirect

Another exception exists for taxpayers who raise, harvest, or grow trees.[1165] Under this exception, IRC section 263A does not apply to trees raised, harvested, or grown by the taxpayer (other than trees bearing fruit, nuts, or other crops, or ornamental trees) and any real property underlying such trees. Similarly, the UNICAP rules do not apply to any animal or plant having a reproductive period of two years or less, which is produced by a taxpayer in a farming business (unless the taxpayer is required to use an accrual method of accounting under IRC section 447 or 448(a)(3)).[1166]

Freelance authors, photographers, and artists also are exempt from IRC section 263A for any qualified creative expenses.[1167] Qualified creative expenses are defined as amounts paid or incurred by an individual in the trade or business of being a writer, photographer, or artist. However, such term does not include any expense related to printing, photographic plates, motion picture files, video tapes, or similar items.

New Federal Law (IRC section 263A)

The provision excludes the aging periods for beer, wine, and distilled spirits from the production period for purposes of the UNICAP interest capitalization rules. Thus, under the provision, producers of beer, wine and distilled spirits are able to deduct interest expenses (subject to any other applicable limitation) attributable to a shorter production period.

Effective Dates

The provision is effective for interest costs paid or accrued in calendar years beginning after December 31, 2017, and does not apply to interest costs paid or accrued after December 31, 2019.

California Law (R&TC sections 17201 and 24422.3)

California conforms, under the PITL and CTL, to the federal rules for capitalization and inclusion in inventory for costs of certain expenses, also known as the UNICAP rules, under IRC section 263A, as of the "specified date" of January 1, 2015,[1168] but does not conform to the exception to the UNICAP rules for the allocation of interest for the production period for beer, wine, and distilled spirits.

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costs beyond those normally capitalized for financial accounting purposes. Treasury Regulation sections 1.263A-2(b)(3)(iv). However, the Chairman's Mark of the "Tax Cuts and Jobs Act" proposes to expand the exception for small taxpayers from the uniform capitalization rules. Under the provision, any producer or reseller that meets the $15 million gross receipts test is exempted from the application of IRC section 263A. See section III.B.4 of *Description of the Chairman's Mark of the "Tax Cuts and Jobs Act"* (JCX-51-17), November 9, 2017.

[1165] IRC section 263A(c)(5).

[1166] IRC section 263A(d). See also section III.B.3 of *Description of the Chairman's Mark of the ''Tax Cuts and Jobs Act"* (JCX-51-17), November 9, 2017, which expands the universe of farming C corporations that may use the cash method to include any farming C corporation that meets the $15 million gross receipts test.

[1167] IRC section 263A(h).

[1168] R&TC section 17024.5 and 23051.5.

Impact on California Revenue

Estimated Conformity Revenue Impact of Production Period for Beer, Wine, and Distilled Spirits For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	- $4,100,000	- $2,100,000	- $700,000

Section	Section Title
13802	Reduced Rate of Excise Tax on Beer

Background

Federal excise taxes are imposed at different rates on distilled spirits, wine, and beer and are imposed on these products when produced or imported. Generally, these excise taxes are administered and enforced by the FTB, except the taxes on imported bottled distilled spirits, wine, and beer are collected by the Customs and Border Protection Bureau (the CBP) of the Department of Homeland Security (under delegation by the Secretary of the Treasury).

Liability for the excise tax on beer also come into existence when the alcohol is produced but is not payable until the beer is removed from the brewery for consumption or sale. Generally, beer may be transferred between commonly owned breweries without payment of tax; however, tax liability follows these products. Imported bulk beer may be released from customs custody without payment of tax and transferred in bond to a brewery. Beer may be exported without payment of tax and may be withdrawn without payment of tax or free of tax from the production facility for certain authorized uses, including industrial uses and non-beverage uses.

The rate of tax on beer is $18 per barrel (31 gallons).[1169] Small brewers are subject to a reduced tax rate of $7 per barrel on the first 60,000 barrels of beer domestically produced and removed each year.[1170] Small brewers are defined as brewers producing fewer than two million barrels of beer during a calendar year. The credit reduces the effective per-gallon tax rate from approximately 58 cents per gallon to approximately 22.6 cents per gallon for this beer.

In the case of a controlled group, the two million barrel limitation for small brewers is applied to the controlled group, and the 60,000 barrels eligible for the reduced rate of tax, are apportioned among the brewers who are component members of such group. The term “controlled group” has the meaning assigned to it by IRC section 1563(a), except that the phrase “more than 50 percent” is substituted for the phrase “at least 80 percent” in each place it appears in IRC section 1563(a).

[1169] IRC section 5051.
[1170] IRC section 5051(a)(2).

Individuals may produce limited quantities of beer for personal or family use without payment of tax during each calendar year. The limit is 200 gallons per calendar year for households of two or more adults and 100 gallons per calendar year for single-adult households.

New Federal Law (IRC section 5051)

The provision lowers the rate of tax on beer to $16 per barrel on the first six million barrels brewed by the brewer or imported by the importer. In general, in the case of a controlled group of brewers, the six million barrel limitation is applied and apportioned at the level of the controlled group. Beer brewed or imported in excess of the six million barrel limit would continue to be taxed at $18 per barrel. In the case of small brewers, such brewers would be taxed at a rate of $3.50 per barrel on the first 60,000 barrels domestically produced, and $16 per barrel on any further barrels produced. The same rules applicable to controlled groups under present law apply with respect to this limitation.

For barrels of beer that have been brewed or produced outside of the United States and imported into the United States, the reduced tax rate may be assigned by the brewer to any importer of such barrels pursuant to requirements set forth by the Secretary of the Treasury in consultation with the Secretary of Health and Human Services and the Secretary of the Department of Homeland Security. These requirements are to include: (1) a limitation to ensure that the number of barrels of beer for which the reduced tax rate has been assigned by a brewer to any importer does not exceed the number of barrels of beer brewed or produced by such brewer during the calendar year which were imported into the United States by such importer; (2) procedures that allow a brewer and an importer to elect whether to receive the reduced tax rate; (3) requirements that the brewer provide any information as the Secretary of the Treasury determines necessary and appropriate for purposes of assignment of the reduced tax rate; and (4) procedures that allow for revocation of eligibility of the brewer and the importer for the reduced tax rate in the case of erroneous or fraudulent information provided in (3) which the Secretary of the Treasury deems to be material for qualifying for the reduced tax rate.

Any importer making an election to receive the reduced tax rate shall be deemed to be a member of the controlled group of the brewer, within the meaning of IRC section 1563(a), except that the phrase “more than 50 percent” is substituted for the phrase “at least 80 percent” in each place it appears in IRC section 1563(a).[1171]

Under rules issued by the Secretary of the Treasury, two or more entities (whether or not under common control) that produce beer marketed under a similar brand, license, franchise, or other arrangement shall be treated as a single taxpayer for purposes of the excise tax on beer.

Effective Dates

The provision is effective for beer removed after December 31, 2017.

[1171] Members of the controlled group may include foreign corporations.

California Law

The FTB does not administer these types of excise taxes.

Impact on California Revenue

The FTB does not administer these types of excise taxes.

Section	Section Title
13803	Transfer of Beer between Bonded Facilities

Background

Federal excise taxes are imposed at different rates on distilled spirits, wine, and beer and are imposed on these products when produced or imported. Generally, these excise taxes are administered and enforced by the FTB, except the taxes on imported bottled distilled spirits, wine, and beer are collected by the Customs and Border Protection Bureau (the CBP) of the Department of Homeland Security (under delegation by the Secretary of the Treasury). The rate of tax on beer is $18 per barrel (31 gallons).[1172]

Liability for the excise tax on beer also come into existence when the alcohol is produced but is not payable until the beer is removed from the brewery for consumption or sale. Generally, beer may be transferred between commonly owned breweries without payment of tax; however, tax liability follows these products. Imported bulk beer may be released from customs custody without payment of tax and transferred in bond to a brewery. Beer may be exported without payment of tax and may be withdrawn without payment of tax or free of tax from the production facility for certain authorized uses, including industrial uses and non-beverage uses.

Small domestic brewers are subject to a reduced tax rate of $7 per barrel on the first 60,000 barrels of beer removed each year.[1173] Small brewers are defined as brewers producing fewer than two million barrels of beer during a calendar year. The credit reduces the effective per-gallon tax rate from approximately 58 cents per gallon to approximately 22.6 cents per gallon for this beer.

Individuals may produce limited quantities of beer for personal or family use without payment of tax during each calendar year. The limit is 200 gallons per calendar year for households of two or more adults and 100 gallons per calendar year for single-adult households.

[1172] IRC section 5051.
[1173] IRC section 5051(a)(2).

Transfer Rules and Removals without Tax

Certain removals or transfers of beer are exempt from tax. Beer may be transferred without payment of the tax between bonded premises under certain conditions specified in the regulations.[1174] The tax liability accompanies the beer that is transferred in bond. However, beer may only be transferred free of tax between breweries if both breweries are owned by the same brewer.

New Federal Law (IRC section 5414)

The provision relaxes the shared ownership requirement of IRC section 5414. Thus, under the provision, a brewer may transfer beer from one brewery to another without incurring tax, provided that: (i) the breweries are owned by the same person; (ii) one brewery owns a controlling interest in the other; (iii) the same person or persons have a controlling interest in both breweries; or (iv) the proprietors of the transferring and receiving premises are independent of each other, and the transferor has divested itself of all interest in the beer so transferred, and the transferee has accepted responsibility for payment of the tax.

For purposes of transferring the tax liability pursuant to (iv) above, such relief from liability shall be effective from the time of removal from the transferor's bonded premises, or from the time of divestment, whichever is later.

Effective Dates

The provision applies to any calendar quarters beginning after December 31, 2017, and does not apply for calendar quarters beginning after December 31, 2019.

California Law

The FTB does not administer these types of excise taxes.

Impact on California Revenue

The FTB does not administer these types of excise taxes.

[1174] IRC section 5414.

Section	Section Title
13804	Reduced Rate of Excise Tax on Certain Wine

Background

In General

Under present law, excise taxes are imposed at different rates on wine, depending on the wine's alcohol content and carbonation levels. The following table outlines the present rates of tax on wine.

Tax (and Code Section)	Tax Rates
Wines (IRC section 5041)	
"Still wines" [1175] not more than 14 percent alcohol	\$1.07 per wine gallon
"Still wines" more than 14 percent, but not more than 21 percent, alcohol.	\$1.57 per wine gallon
"Still wines" more than 21 percent, but not more than 24 percent, alcohol	\$3.15 per wine gallon
"Still wines" more than 24 percent alcohol	\$13.50 per proof gallon (taxed as distilled spirits)
Champagne and other sparkling wines	\$3.40 per wine gallon
Artificially carbonated wines	\$3.30 per wine gallon

Liability for the excise taxes on wine come into existence when the wine is produced but is not payable until the wine is removed from the bonded wine cellar or winery for consumption or sale. Generally, bulk and bottled wine may be transferred in bond between bonded premises; however, tax liability follows these products. Bulk natural wine may be released from customs custody without payment of tax and transferred in bond to a winery. Wine may be exported without payment of tax and may be withdrawn without payment of tax or free of tax from the production facility for certain authorized uses, including industrial uses and non-beverage uses.

Reduced Rates and Exemptions for Certain Wine Producers

Wineries having aggregate annual production not exceeding 250,000 gallons ("small domestic producers") receive a credit against the wine excise tax equal to 90 cents per gallon (the amount of a wine tax increase enacted in 1990) on the first 100,000 gallons of wine domestically produced and removed during a calendar year.[1176] The credit is reduced (but not below zero) by one percent for each 1,000 gallons produced in excess of 150,000 gallons; the credit does not apply to sparkling wines. In the case of a controlled group, the 250,000 gallon limitation for wineries is applied to the controlled group, and the 100,000 gallons eligible for the credit, are apportioned among the wineries who are component members of such group. The term "controlled group" has the meaning assigned to it by IRC section 1563(a), except that the phrase

[1175] A "still wine" is a non-sparkling wine. Most common table wines are still wines.
[1176] IRC section 5041(c).

"more than 50 percent" is substituted for the phrase "at least 80 percent" in each place it appears in IRC section 1563(a).

Individuals may produce limited quantities of wine for personal or family use without payment of tax during each calendar year. The limit is 200 gallons per calendar year for households of two or more adults and 100 gallons per calendar year for single adult households.

New Federal Law (IRC section 5041)

The provision modifies the credit against the wine excise tax for small domestic producers, by removing the 250,000 wine gallon domestic production limitation (and thus making the credit available for all wine producers and importers). Additionally, under the provision, sparkling wine producers and importers are now eligible for the credit. With respect to wine produced in, or imported into, the United States during a calendar year, the credit amount is (1) $1.00 per wine gallon for the first 30,000 wine gallons of wine, plus; (2) 90 cents per wine gallon on the next 100,000 wine gallons of wine, plus; (3) 53.5 cents per wine gallon on the next 620,000 wine gallons of wine.[1177] There is no phase-out of the credit.

In the case of any wine gallons of wine that have been produced outside of the United States and imported into the United States, the tax credit allowable may be assigned by the person who produced such wine (the "foreign producer") to any electing importer of such wine gallons pursuant to requirements established by the Secretary of the Treasury, in consultation with the Secretary of Health and Human Services and the Secretary of the Department of Homeland Security. These requirements are to include: (1) a limitation to ensure that the number of wine gallons of wine for which the tax credit has been assigned by a foreign producer to any importer does not exceed the number of wine gallons of wine produced by such foreign producer, during the calendar year, which were imported into the United States by such importer; (2) procedures that allow the election of a foreign producer to assign, and an importer to receive, the tax credit; (3) requirements that the foreign producer provide any information that the Secretary of the Treasury determines to be necessary and appropriate for purposes of assigning the tax credit; and (4) procedures that allow for revocation of eligibility of the foreign producer and the importer for the tax credit in the case of erroneous or fraudulent information provided in (3) which the Secretary of the Treasury deems to be material for qualifying for the reduced tax rate.

Any importer making an election to receive the reduced tax rate shall be deemed to be a member of the controlled group of the winemaker, within the meaning of IRC section 1563(a), except that the phrase "more than 50 percent" is substitute for the phrase "at least 80 percent" in each place it appears in IRC section 1563(a).[1178]

[1177] The credit rate for hard cider is tiered at the same level of production or importation, but is equal to 6.2 cents, 5.6 cents and 3.3 cents, respectively.
[1178] Members of the controlled group may include foreign corporations.

Effective Dates

The provision applies to wine removed after December 31, 2017, and does not apply for wine removed in calendar quarters beginning after December 31, 2019.

California Law

The FTB does not administer these types of excise taxes.

Impact on California Revenue

The FTB does not administer these types of excise taxes.

Section	Section Title
13805	Adjustment of Alcohol Content Level for Application of Excise Tax Rates

Background

In General

Under present law, excise taxes are imposed at different rates on wine, depending on the wine's alcohol content and carbonation levels. The following table outlines the present rates of tax on wine.

Tax (and Code Section)	Tax Rates
Wines (IRC section 5041)	
"Still wines" [1179] not more than 14 percent alcohol	$1.07 per wine gallon
"Still wines" more than 14 percent, but not more than 21 percent, alcohol.	$1.57 per wine gallon
"Still wines" more than 21 percent, but not more than 24 percent, alcohol	$3.15 per wine gallon
"Still wines" more than 24 percent alcohol	$13.50 per proof gallon (taxed as distilled spirits)
Champagne and other sparkling wines	$3.40 per wine gallon
Artificially carbonated wines	$3.30 per wine gallon

Liability for the excise taxes on wine come into existence when the wine is produced but is not payable until the wine is removed from the bonded wine cellar or winery for consumption or sale. Generally, bulk and bottled wine may be transferred in bond between bonded premises; however, tax liability follows these products. Bulk natural wine may be released from customs custody without payment of tax and transferred in bond to a winery. Wine may be exported without

[1179] A "still wine" is a non-sparkling wine. Most common table wines are still wines.

payment of tax and may be withdrawn without payment of tax or free of tax from the production facility for certain authorized uses, including industrial uses and non-beverage uses.

Reduced Rates and Exemptions for Certain Wine Producers

Wineries having aggregate annual production not exceeding 250,000 gallons ("small domestic producers") receive a credit against the wine excise tax equal to 90 cents per gallon (the amount of a wine tax increase enacted in 1990) on the first 100,000 gallons of wine domestically produced and removed during a calendar year.[1180] The credit is reduced (but not below zero) by one percent for each 1,000 gallons produced in excess of 150,000 gallons; the credit does not apply to sparkling wines. In the case of a controlled group, the 250,000 gallon limitation for wineries is applied to the controlled group, and the 100,000 gallons eligible for the credit, are apportioned among the wineries who are component members of such group. The term "controlled group" has the meaning assigned to it by IRC section 1563(a), except that the phrase "more than 50 percent" is substituted for the phrase "at least 80 percent" in each place it appears in IRC section 1563(a).

Individuals may produce limited quantities of wine for personal or family use without payment of tax during each calendar year. The limit is 200 gallons per calendar year for households of two or more adults and 100 gallons per calendar year for single adult households.

<u>New Federal Law (IRC section 5041)</u>

The provision modifies alcohol-by-volume levels of the first two tiers of the excise tax on wine, by changing 14 percent to 16 percent. Thus, under the provision, a wine producer or importer may produce or import "still wine" that has an alcohol-by-volume level of up to 16 percent, and remain subject to the lowest rate of $1.07 per wine gallon.

<u>Effective Dates</u>

The provision applies to wine removed after December 31, 2017, and does not apply to wine removed after December 31, 2019.

<u>California Law</u>

The FTB does not administer these types of excise taxes.

<u>Impact on California Revenue</u>

The FTB does not administer these types of excise taxes.

[1180] IRC section 5041(c).

Section	Section Title
13806	Definition of Mead and Low Alcohol by Volume Wine

Background

In General

Under present law, excise taxes are imposed at different rates on wine, depending on the wine's alcohol content and carbonation levels. The following table outlines the present rates of tax on wine.

Tax (and Code Section)	Tax Rates
Wines (IRC section 5041)	
"Still wines" [1181] not more than 14 percent alcohol	\$1.07 per wine gallon
"Still wines" more than 14 percent, but not more than 21 percent, alcohol.	\$1.57 per wine gallon
"Still wines" more than 21 percent, but not more than 24 percent, alcohol	\$3.15 per wine gallon
"Still wines" more than 24 percent alcohol	\$13.50 per proof gallon (taxed as distilled spirits)
Champagne and other sparkling wines	\$3.40 per wine gallon
Artificially carbonated wines	\$3.30 per wine gallon

Liability for the excise taxes on wine come into existence when the wine is produced but is not payable until the wine is removed from the bonded wine cellar or winery for consumption or sale. Generally, bulk and bottled wine may be transferred in bond between bonded premises; however, tax liability follows these products. Bulk natural wine may be released from customs custody without payment of tax and transferred in bond to a winery. Wine may be exported without payment of tax and may be withdrawn without payment of tax or free of tax from the production facility for certain authorized uses, including industrial uses and non-beverage uses.

Reduced Rates and Exemptions for Certain Wine Producers

Wineries having aggregate annual production not exceeding 250,000 gallons ("small domestic producers") receive a credit against the wine excise tax equal to 90 cents per gallon (the amount of a wine tax increase enacted in 1990) on the first 100,000 gallons of wine domestically produced and removed during a calendar year.[1182] The credit is reduced (but not below zero) by one percent for each 1,000 gallons produced in excess of 150,000 gallons; the credit does not apply to sparkling wines. In the case of a controlled group, the 250,000 gallon limitation for wineries is applied to the controlled group, and the 100,000 gallons eligible for the credit, are apportioned among the wineries who are component members of such group. The term "controlled group" has the meaning assigned to it by IRC section 1563(a), except that the phrase "more than 50 percent" is substituted for the phrase "at least 80 percent" in each place it appears in IRC section 1563(a).

[1181] A "still wine" is a non-sparkling wine. Most common table wines are still wines.
[1182] IRC section 5041(c).

Individuals may produce limited quantities of wine for personal or family use without payment of tax during each calendar year. The limit is 200 gallons per calendar year for households of two or more adults and 100 gallons per calendar year for single adult households.

New Federal Law (IRC section 5041)

The provision designates mead and certain sparkling wines to be taxed at the lowest rate applicable to "still wine," of $1.07 per wine gallon of wine. Mead is defined as a wine that contains not more than 0.64 grams of carbon dioxide per hundred milliliters of wine,[1183] which is derived solely from honey and water, contains no fruit product or fruit flavoring, and contains less than 8.5 percent alcohol-by-volume. The sparkling wines eligible to be taxed at the lowest rate are those wines that contain not more than 0.64 grams of carbon dioxide per hundred milliliters of wine,[1184] which are derived primarily from grapes or grape juice concentrate and water, which contain no fruit flavoring other than grape, and which contain less than 8.5 percent alcohol by volume.

Effective Dates

The provision applies to wine removed after December 31, 2017, and does not apply to wine removed after December 31, 2019.

California Law

The FTB does not administer these types of excise taxes.

Impact on California Revenue

The FTB does not administer these types of excise taxes.

[1183] The Secretary is authorized to prescribe tolerances to this limitation as may be reasonably necessary in good commercial practice.
[1184] The Secretary is authorized to prescribe tolerances to this limitation as may be reasonably necessary in good commercial practice.

Section	Section Title
13807	Reduced Rate of Excise Tax on Certain Distilled Spirits

Background

An excise tax is imposed on all distilled spirits produced in, or imported into, the United States.[1185] The tax liability legally comes into existence the moment the alcohol is produced or imported but payment of the tax is not required until a subsequent withdrawal or removal from the distillery, or, in the case of an imported product, from customs custody or bond.[1186]

Distilled spirits are taxed at a rate of $13.50 per proof gallon.[1187] Liability for the excise tax on distilled spirits comes into existence when the alcohol is produced but is not determined and payable until bottled distilled spirits are removed from the bonded premises of the distilled spirits plant where they are produced. Generally, bulk distilled spirits may be transferred in bond between bonded premises; however, tax liability follows these products. Imported bulk distilled spirits may be released from customs custody without payment of tax and transferred in bond to a distillery. Distilled spirits be exported without payment of tax and may be withdrawn without payment of tax or free of tax from the production facility for certain authorized uses, including industrial uses and non-beverage uses.

A portion of the revenues from the distilled spirits excise tax imposed on rum imported or brought into[1188] the United States (less certain administrative costs) is transferred ("covered over") to Puerto Rico and the U.S. Virgin Islands.[1189] The amount covered over is $10.50 per proof gallon ($13.25 per proof gallon during the period from July 1, 1999, through December 31, 2016). Eligible distilled spirits wholesale distributors and distillers receive an income tax credit for the average cost of carrying previously imposed excise tax on beverages stored in their warehouses.[1190]

New Federal Law (IRC section 5001)

The provision institutes a tiered rate for distilled spirits. The rate of tax is lowered to $2.70 per proof gallon on the first 100,000 proof gallons of distilled spirits, $13.34 for all proof gallons in excess of that amount but below 22,130,000 proof gallons, and $13.50 for amounts thereafter. The provision contains rules so as to prevent members of the same controlled group from

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1185 IRC section 5001.
1186 IRC sections 5006, 5043, and 5054. In general, proprietors of distilled spirit plants, proprietors of bonded wine cellars, brewers, and importers are liable for the tax.
1187 A "proof gallon" is a U.S. liquid gallon of proof spirits, or the alcoholic equivalent thereof. Generally a proof gallon is a U.S. liquid gallon consisting of 50 percent alcohol. On lesser quantities, the tax is paid proportionately. Credits are allowed for wine content and flavors content of distilled spirits. IRC section 5010.
1188 Because Puerto Rico is inside U.S. customs territory, articles entering the United States from that commonwealth are "brought into" rather than "imported into" the U.S.
1189 IRC section 7652.
1190 IRC section 5011. IRC section 5011 is administered and enforced by the IRS.

receiving the lower rate on more than 100,000 proof gallons of distilled spirits. Importers of distilled spirits are eligible for the lower rates.

Effective Dates

The provision applies to distilled spirits removed after December 31, 2017, and does not apply to distilled spirits removed after December 31, 2019.

California Law

The FTB does not administer these types of excise taxes.

Impact on California Revenue

The FTB does not administer these types of excise taxes.

Section	Section Title
13808	Bulk Distilled Spirits

Background

An excise tax is imposed on all distilled spirits produced in, or imported into, the United States.[1191] The tax liability legally comes into existence the moment the alcohol is produced or imported but payment of the tax is not required until a subsequent withdrawal or removal from the distillery, or, in the case of an imported product, from customs custody or bond.[1192]

Distilled spirits are taxed at a rate of $13.50 per proof gallon.[1193] Liability for the excise tax on distilled spirits comes into existence when the alcohol is produced but is not determined and payable until bottled distilled spirits are removed from the bonded premises of the distilled spirits plant where they are produced. Generally, bulk distilled spirits may be transferred in bond between bonded premises; however, tax liability follows these products. Additionally, in order to transfer such spirits in bond without payment of tax, such spirits may not be transferred in containers smaller than one gallon.[1194] Imported bulk distilled spirits may be released from customs custody without payment of tax and transferred in bond to a distillery. Distilled spirits be exported without payment of tax and may be withdrawn without payment of tax or free of tax from

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[1191] IRC section 5001.
[1192] IRC Sections 5006, 5043, and 5054. In general, proprietors of distilled spirit plants, proprietors of bonded wine cellars, brewers, and importers are liable for the tax.
[1193] A "proof gallon" is a U.S. liquid gallon of proof spirits, or the alcoholic equivalent thereof. Generally a proof gallon is a U.S. liquid gallon consisting of 50 percent alcohol. On lesser quantities, the tax is paid proportionately. Credits are allowed for wine content and flavors content of distilled spirits. IRC section 5010.
[1194] IRC section 5212.

the production facility for certain authorized uses, including industrial uses and non-beverage uses.

A portion of the revenues from the distilled spirits excise tax imposed on rum imported or brought into[1195] the United States (less certain administrative costs) is transferred ("covered over") to Puerto Rico and the U.S. Virgin Islands.[1196] The amount covered over is $10.50 per proof gallon ($13.25 per proof gallon during the period from July 1, 1999, through December 31, 2016).

Eligible distilled spirits wholesale distributors and distillers receive an income tax credit for the average cost of carrying previously imposed excise tax on beverages stored in their warehouses.[1197]

New Federal Law (IRC section 5212)

The provision allows distillers to transfer spirits in approved containers other than bulk containers in bond without payment of tax.

Effective Dates

The provision applies to distilled spirits transferred in bond after December 31, 2017, and does not apply to distilled spirits transferred in bond after December 31, 2019.

California Law

The FTB does not administer these types of excise taxes.

Impact on California Revenue

The FTB does not administer these types of excise taxes.

[1195] Because Puerto Rico is inside U.S. customs territory, articles entering the United States from that commonwealth are "brought into" rather than "imported into" the U.S.
[1196] IRC section 7652.
[1197] IRC section 5011. IRC section 5011 is administered and enforced by the IRS.

Subpart B—Miscellaneous Provisions

Section	Section Title
13821	Modification of Tax Treatment of Alaska Native Corporations and Settlement Trusts

Background

The Alaska Native Claims Settlement Act (ANCSA)[1198] established Native Corporations[1199] to hold property for Alaska Natives. Alaska Natives are generally the only permitted common shareholders of those corporations under section 7(h) of ANCSA, unless a Native Corporation specifically allows other shareholders under specified procedures.

ANCSA permits a Native Corporation to transfer money or other property to an Alaska Native Settlement Trust (Settlement Trust) for the benefit of beneficiaries who constitute all or a class of the shareholders of the Native Corporation, to promote the health, education and welfare of beneficiaries and to preserve the heritage and culture of Alaska Natives.[1200]

Native Corporations and Settlement Trusts, as well as their shareholders and beneficiaries, are generally subject to tax under the same rules and in the same manner as other taxpayers that are corporations, trusts, shareholders, or beneficiaries.

Special tax rules enacted in 2001 allow an election to use a more favorable tax regime for transfers of property by a Native Corporation to a Settlement Trust and for income taxation of the Settlement Trust. There is also simplified reporting to beneficiaries.

Under the special tax rules, a Settlement Trust may make an irrevocable election to pay tax on taxable income at the lowest rate specified for individuals, (rather than the highest rate that is generally applicable to trusts) and to pay tax on capital gains at a rate consistent with being subject to such lowest rate of tax. As described further below, beneficiaries may generally thereafter exclude from gross income distributions from a trust that has made this election. Also, contributions from a Native Corporation to an electing Settlement Trust generally will not result in the recognition of gross income by beneficiaries on account of the contribution. An electing Settlement Trust remains subject to generally applicable requirements for classification and taxation as a trust.

A Settlement Trust distribution is excludable from the gross income of beneficiaries to the extent of the taxable income of the Settlement Trust for the taxable year and all prior taxable years for which an election was in effect, decreased by income tax paid by the Trust, plus tax-exempt interest from State and local bonds for the same period. Amounts distributed in excess of the

[1198] 43 U.S.C. 1601 *et seq.*
[1199] Defined at 43 U.S.C. 1602(m).
[1200] With certain exceptions, once an Alaska Native Corporation has made a conveyance to a Settlement Trust, the assets conveyed shall not be subject to attachment, distraint, or sale or execution of judgment, except with respect to the lawful debts and obligations of the Settlement Trust.

amount excludable is taxed to the beneficiaries as if distributed by the sponsoring Native Corporation in the year of distribution by the Trust, which means that the beneficiaries must include in gross income as dividends the amount of the distribution, up to the current and accumulated earnings and profits of the Native Corporation. Amounts distributed in excess of the current and accumulated earnings and profits are not included in gross income by the beneficiaries.

A special loss disallowance rule reduces (but not below zero) any loss that would otherwise be recognized upon disposition of stock of a sponsoring Native Corporation by a proportion, determined on a per share basis, of all contributions to all electing Settlement Trusts by the sponsoring Native Corporation. This rule prevents a stockholder from being able to take advantage of a decrease in value of a Native Corporation that is caused by a transfer of assets from the Native Corporation to a Settlement Trust.

The fiduciary of an electing Settlement Trust is obligated to provide certain information relating to distributions from the trust in lieu of reporting requirements under IRC section 6034A.

The election to pay tax at the lowest rate is not available in certain disqualifying cases where transfer restrictions have been modified to allow a transfer of either: (a) a beneficial interest that would not be permitted by section 7(h) of the ANCSA if the interest were Settlement common stock, or (b) any stock in an Alaska Native Corporation that would not be permitted by section 7(h) if it were Settlement common stock and the Native Corporation thereafter makes a transfer to the Trust. Where an election is already in effect at the time of such disqualifying transfers, the special rules applicable to an electing trust cease to apply and rules generally applicable to trusts apply. In addition, the distributable net income of the trust is increased by undistributed current and accumulated earnings and profits of the trust, limited by the fair market value of trust assets at the date the trust becomes so disposable. The effect is to cause the trust to be taxed at regular trust rates on the amount of recomputed distributable net income not distributed to beneficiaries, and to cause the beneficiaries to be taxed on the amount of any distributions received consistent with the applicable tax rate bracket.

<u>New Federal Law (IRC sections 139G, 247, 6039H)</u>

The provision comprises three separate but related sections. The first section allows a Native Corporation to assign certain payments described in ANCSA to a Settlement Trust without having to recognize gross income from those payments, provided the assignment is in writing and the Native Corporation has not received the payment prior to assignment. The Settlement Trust is required to include the assigned payment in gross income when received.

The second section allows a Native Corporation to elect annually to deduct contributions made to a Settlement Trust. If the contribution is in cash, the deduction is in the amount of cash contributed. If the contribution is property other than cash, the deduction is the amount of the Native Corporation's basis in the contributed property (or the fair market value of such property, if less than the Native Corporation's basis), and no gain or loss can be recognized on the contribution. The Native Corporation's deduction is limited to the amount of its taxable income for that year, and any unused deduction may be carried forward 15 additional years. The Native

Corporation's earnings and profits for the taxable year are reduced by the amount of any deduction claimed for that year.

Generally, the Settlement Trust must include income equal to the deduction by the Native Corporation. For contributions of property other than cash, the Settlement Trust takes a basis in the property equal to its basis in the hands of the Native Corporation immediately before the contribution (or the fair market value of such property, if less than the Native Corporation's basis), and may elect to defer recognition of income associated with such property until the Settlement Trust sells or disposes of the property. In that case, any income that is deferred (i.e., the amount of income that would have been included upon contribution absent the election to defer) is treated as ordinary income, while any gain in excess of the amount that is deferred takes the same character as if the election had not been made. If property subject to this election is disposed of within the first taxable year subsequent to the taxable year in which the property was contributed to the Settlement Trust, the election is voided with respect to the property, and the Settlement Trust is required to pay any tax applicable to the disposition of the property, including interest, as well as a penalty of 10 percent of the amount of the tax. The provision provides for a four year assessment period in which to assess the tax, interest, and penalty amounts. The provision permits the amendment of the terms of any Settlement Trust agreement to allow this election within one year of the enactment of the provision, with certain restrictions.

The third section of the provision requires any Native Corporation which has made an election to deduct contributions to a Settlement Trust as described above to furnish a statement to the Settlement Trust containing: (1) the total amount of contributions; (2) whether such contribution was in cash; (3) for non-cash contributions, the date that such property was acquired by the Native Corporation and the adjusted basis of such property on the contribution date; (4) the date on which each contribution was made to the Settlement Trust; and (5) such information as the Secretary determines is necessary for the accurate reporting of income relating to such contributions.

Effective Dates

The provision relating to the exclusion for ANCSA payments assigned to Settlement Trusts is effective to taxable years beginning after December 31, 2016.

The provision relating to the deduction of contributions is effective for taxable years for which the Native Corporation's refund statute of limitations period has not expired, and the provision provides a one-year waiver of the refund statute of limitations period in the event that the limitation period expires before the end of the one-year period beginning on the date of enactment, December 22, 2017.

The provision relating to the reporting requirement applies to taxable years beginning after December 31, 2016.

California Law (R&TC sections 18631)

California does not conform to the modification of tax treatment of Alaska Native Corporations and Settlement Trusts under IRC sections 139G and 247, and has no similar provision.

California law provides, under the AFITL,[1201] that the FTB may require a copy of any information return required to be filed with the Secretary of the Treasury under IRC section 6039H, relating to the requirement that any Native Corporation which has made an election to deduct contributions to a Settlement Trust to furnish a statement to the Settlement Trust, at the time and in the form and manner as the FTB may, by forms and instructions, require.

Impact on California Revenue

Not applicable.

Section	Section Title
13822	Amounts Paid for Aircraft Management Services

Background

Excise Tax on Taxable Transportation by Air

For domestic passenger transportation, IRC section 4261 imposes an excise tax on amounts paid for taxable transportation. In general, for domestic flights, the tax consists of two parts: a 7.5 percent *ad valorem* tax applied to the amount paid and a flat dollar amount for each flight segment (consisting of one takeoff and one landing). "Taxable transportation" generally means transportation by air which begins and ends in the United States. The tax is paid by the person making the payment subject to tax and the tax is collected by the person receiving the payment. For commercial freight aviation, the *ad valorem* tax is 6.25 percent of the amount paid for transportation.

In determining whether a flight constitutes taxable transportation and whether the amounts paid for such transportation are subject to tax, the IRS has looked at who has "possession, command, and control" of the aircraft based on the relevant facts and circumstances.[1202]

Applicability to Aircraft Management Services

Generally, an aircraft management services company (management company) has as its business purpose the management of aircraft owned by other corporations or individuals (aircraft owners). In this function, management companies provide aircraft owners, among other things, with

[1201] R&TC section 18631(c)(25).
[1202] See, *e.g.,* Revenue Ruling 60-311, 1960-2 C.B. 341, which held that, since the company in question retains the elements of possession, command, and control of the aircraft and performs all services in connection with the operation of the aircraft, the company is, in fact, furnishing taxable transportation to the lessee; and the tax on the transportation of persons applies to the portion of the total payment which is allocable to the transportation of persons, provided such allocation is made on a fair and reasonable basis. If no allocation is made, the tax applies to the total payment for the lease of the aircraft.

administrative and support services (such as scheduling, flight planning, and weather forecasting), aircraft maintenance services, the provision of pilots and crew, and compliance with regulatory standards. Although the arrangement between management companies and aircraft owners may vary, it is our understanding that aircraft owners generally pay management companies a monthly fee to cover the fixed expenses of maintaining the aircraft (such as insurance, maintenance, and recordkeeping) and a variable fee to cover the cost of using the aircraft (such as the provision of pilots, crew, and fuel).

In March 2012, the IRS issued a Chief Counsel Advice determining that a management company provided all of the essential elements necessary for providing transportation by air and the owner relinquished possession, command and control to the management company.[1203] Thus, the management company was determined to be providing taxable transportation to the owner and was required to collect the appropriate federal excise tax from the aircraft owner and remit it to the IRS. The Chief Counsel Advice resulted in increased audit activity by the IRS on aircraft management companies.

In May 2013, the IRS suspended assessment of the federal excise tax with respect to aircraft management services while it developed guidance on the tax treatment of aircraft management issues. In a 2015 opinion,[1204] an Ohio district court held that the existing revenue rulings (in effect for the tax period April 1, 2005, through June 30, 2009, the period that was the subject of the litigation) regarding the possession, command and control test, failed to provide precise and not speculative notice of a collection obligation as it related to whole-aircraft management contracts.[1205] As a result, the court ruled as a matter of law that because precise and not speculative notice was not received, the aircraft management company plaintiff did not have a collection obligation with respect to the Federal excise tax on payments received for whole-aircraft management services.

In 2017, the IRS decided not to pursue examination of the issue of whether amounts paid to aircraft companies by the owners or lessors of the aircraft are taxable until further guidance is made available. According to the IRS, for any exam in suspense the aircraft management fee issue was conceded and the taxpayers were notified accordingly.[1206] The IRS has not issued further guidance on this issue.

<u>New Federal Law (IRC section 4261)</u>

The Senate amendment exempts certain payments related to the management of private aircraft from the excise taxes imposed on taxable transportation by air. Exempt payments are those amounts paid by an aircraft owner for management services related to maintenance and support of the owner's aircraft or flights on the owner's aircraft. Applicable services include support

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[1203] CCA 2012-10026 (March, 2012).
[1204] *Netjets Large Aircraft Inc. v. United States,* 116 A.F.T.R. 2d. 2015-6776 (S.D. Ohio, 2015).
[1205] The district court held that such notice is required to persons having a deputy tax collection obligation under the rationale of the Supreme Court's holding in *Central Illinois Public Service Company v. United States,* 435 U.S. 21 (1978).
[1206] See also, Kerry Lynch, *IRS To Shelve Pending Audits on Aircraft Management Fees, AINonline (July 17, 2017)* http://www.ainonline.com/aviation-news/business-aviation/2017-07-17/ irs-shelve-pending-audits-aircraft-management-fees.

activities related to the aircraft itself, such as its storage, maintenance, and fueling, and those related to its operation, such as the hiring and training of pilots and crew, as well as administrative services such as scheduling, flight planning, weather forecasting, obtaining insurance, and establishing and complying with safety standards. Aircraft management services also include such other services as are necessary to support flights operated by an aircraft owner.

Payments for flight services are exempt only to the extent that they are attributable to flights on an aircraft owner's own aircraft.[1207] Thus, if an aircraft owner makes a payment to a management company for the provision of a pilot and the pilot provides his services on the aircraft owner's aircraft, such payment is not subject to Federal excise tax. However, if the pilot provides his services to the aircraft owner on an aircraft other than the aircraft owner's (for instance, on an aircraft that is part of a fleet of aircraft available for third-party charter services), then such payment is subject to Federal excise tax.

The provision provides a pro rata allocation rule in the event that a monthly payment made to a management company is allocated in part to exempt services and flights on the aircraft owner's aircraft, and in part to flights on aircraft other than the aircraft owner's. In such a circumstance, Federal excise tax must be collected on that portion of the payment attributable to flights on aircraft not owned by the aircraft owner.

Under the provision, a lessee of an aircraft is considered an aircraft owner provided that the lease is not a “disqualified lease.” A disqualified lease is any lease of an aircraft from a management company (or a related party) for a term of 31 days or less.

Effective Dates

The provision is effective for amounts paid after the date of enactment, December 22, 2017.

California Law

The FTB does not administer these types of excise taxes.

[1207] Examples of arrangements that cannot qualify a person as an “aircraft owner” include ownership of stock in a commercial airline and participation in a fractional ownership aircraft program. Ownership of stock in a commercial airline cannot qualify an individual as an “aircraft owner” of a commercial airline's aircraft, and amounts paid for transportation on such flights remain subject to the tax under IRC section 4261. Similarly, participation in a fractional ownership aircraft program does not constitute “aircraft ownership” for purposes of this standard. Amounts paid to a fractional ownership aircraft program for transportation under such a program are exempt from the ticket tax under IRC section 4261(j) if the aircraft is operating under subpart K of part 91 of title 14 of the Code of Federal Regulations (“subpart K”), and flights under such program are subject to both the fuel tax levied on non-commercial aviation an additional fuel surtax under IRC section 4043 of the Code. A business arrangement seeking to circumvent that surtax by operating outside of subpart K, allowing an aircraft owner the right to use any of a fleet of aircraft, be it through an aircraft interchange agreement, through holding nominal shares in a fleet of aircraft, or any other arrangement that does not reflect true tax ownership of the aircraft being flown upon, is not considered ownership for purposes of the provision.

Impact on California Revenue

The FTB does not administer these types of excise taxes.

Section	Section Title
13823	Opportunity Zones

Background

The IRC occasionally has provided several incentives aimed at encouraging economic growth and investment in distressed communities by providing federal tax benefits to businesses located within designated boundaries.[1208]

One of these incentives is a federal income tax credit that is allowed in the aggregate amount of 39 percent of a taxpayer investment in a qualified community development entity (CDE).[1209] In general, the credit is allowed to a taxpayer who makes a "qualified equity investment" in a CDE which further invests in a "qualified active low-income community business." CDEs are required to make investments in low income communities (generally communities with 20 percent or greater poverty rate or median family income less than 80 percent of statewide median). The credit is allowed over seven years, five percent in each of the first three years and six percent in each of the next four years. The credit is recaptured if at any time during the seven-year period that begins on the date of the original issue of the investment the entity (1) ceases to be a qualified CDE, (2) the proceeds of the investment cease to be used as required, or (3) the equity investment is redeemed. The Department of Treasury's Community Development Financial Institutions Fund (CDFI) allocates the new markets tax credits.

The maximum annual amount of qualified equity investments is $3.5 billion for calendar years 2010 through 2019. The new markets tax credit is set to expire on December 31, 2019. No amount of unused allocation limitation may be carried to any calendar year after 2024.

[1208] Such designated areas were referred to as empowerment zones, the District of Columbia Enterprise ("DC") Zone, and the Gulf Opportunity ("GO") Zone, and each of these designations and attendant tax incentives have expired. The designations and tax incentives for the DC Zone, and the GO Zone generally expired after December 31, 2011. IRC sections 1400(f), 1400N(h), 1400N(c)(5), 1400N(a)(2)(D), 1400N(a)(7)(C), 1400N(d). The empowerment zones program and attendant tax incentives expired as of December 31, 2016. IRC section 1391(d)(1). There are also areas that were designated as renewal communities under IRC section 1400E which received tax benefits that all expired as of December 31, 2009, except that a zero-percent capital gains rate applies with respect to gain from the sale through December 31, 2014, of a qualified community asset acquired after December 31, 2001, and before January 1, 2010, and held for more than five years. For more information on these programs and attendant tax incentives, see Joint Committee on Taxation, *Incentives for Distressed Communities: Empowerment Zones and Renewal Communities* (JCX- 38-09), October 5, 2009.

[1209] IRC section 45D.

New Federal Law (IRC sections 1400Z-1 and 1400Z-2)

The provision provides for the temporary deferral of inclusion in gross income for capital gains reinvested in a qualified opportunity fund and the permanent exclusion of capital gains from the sale or exchange of an investment in the qualified opportunity fund.

The provision allows for the designation of certain low-income community population census tracts as qualified opportunity zones, where low-income communities are defined in IRC section 45D(e). The designation of a population census tract as a qualified opportunity zone remains in effect for the period beginning on the date of the designation and ending at the close of the tenth calendar year beginning on or after the date of designation.

Governors may submit nominations for a limited number of opportunity zones to the Secretary for certification and designation. If the number of low-income communities in a State is less than 100, the Governor may designate up to 25 tracts; otherwise the Governor may designate tracts not exceeding 25 percent of the number of low-income communities in the State. Governors are required to provide particular consideration to areas that: (1) are currently the focus of mutually reinforcing state, local, or private economic development initiatives to attract investment and foster startup activity; (2) have demonstrated success in geographically targeted development programs such as promise zones, the new markets tax credit, empowerment zones, and renewal communities; and (3) have recently experienced significant layoffs due to business closures or relocations.

The provision provides two main tax incentives to encourage investment in qualified opportunity zones. First, it allows for the temporary deferral of inclusion in gross income for capital gains that are reinvested in a qualified opportunity fund. A qualified opportunity fund is an investment vehicle organized as a corporation or a partnership for the purpose of investing in qualified opportunity zone property (other than another qualified opportunity fund) that holds at least 90 percent of its assets in qualified opportunity zone property. The provision intends that the certification process for a qualified opportunity fund will be done in a manner similar to the process for allocating the new markets tax credit. The provision provides the Secretary authority to carry out the process.

If a qualified opportunity fund fails to meet the 90 percent requirement and unless the fund establishes reasonable cause, the fund is required to pay a monthly penalty of the excess of the amount equal to 90 percent of its aggregate assets, over the aggregate amount of qualified opportunity zone property held by the fund multiplied by the underpayment rate in the IRC. If the fund is a partnership, the penalty is taken into account proportionately as part of each partner's distributive share.

Qualified opportunity zone property includes: any qualified opportunity zone stock, any qualified opportunity zone partnership interest, and any qualified opportunity zone business property. The maximum amount of the deferred gain is equal to the amount invested in a qualified opportunity fund by the taxpayer during the 180-day period beginning on the date of sale of the asset to which the deferral pertains. For amounts of the capital gains that exceed the maximum deferral amount, the capital gains must be recognized and included in gross income as under present law.

If the investment in the qualified opportunity zone fund is held by the taxpayer for at least five years, the basis on the original gain is increased by 10 percent of the original gain. If the opportunity zone asset or investment is held by the taxpayer for at least seven years, the basis on the original gain is increased by an additional 5 percent of the original gain. The deferred gain is recognized on the earlier of the date on which the qualified opportunity zone investment is disposed of or December 31, 2026. Only taxpayers who rollover capital gains of non-zone assets before December 31, 2026, will be able to take advantage of the special treatment of capital gains for non-zone and zone realizations under the provision.

The basis of an investment in a qualified opportunity zone fund immediately after its acquisition is zero. If the investment is held by the taxpayer for at least five years, the basis on the investment is increased by 10 percent of the deferred gain. If the investment is held by the taxpayer for at least seven years, the basis on the investment is increased by an additional five percent of the deferred gain. If the investment is held by the taxpayer until at least December 31, 2026, the basis in the investment increases by the remaining 85 percent of the deferred gain.

The second main tax incentive in the bill excludes from gross income the post-acquisition capital gains on investments in opportunity zone funds that are held for at least 10 years. Specifically, in the case of the sale or exchange of an investment in a qualified opportunity zone fund held for more than 10 years, at the election of the taxpayer the basis of such investment in the hands of the taxpayer shall be the fair market value of the investment at the date of such sale or exchange. Taxpayers can continue to recognize losses associated with investments in qualified opportunity zone funds as under current law.

The Secretary or the Secretary's delegate is required to report annually to Congress on the opportunity zone incentives beginning 5 years after the date of enactment. The report is to include an assessment of investments held by the qualified opportunity fund nationally and at the State level. To the extent the information is available, the report is to include the number of qualified opportunity funds, the amount of assets held in qualified opportunity funds, the composition of qualified opportunity fund investments by asset class, and the percentage of qualified opportunity zone census tracts designated under the provision that have received qualified opportunity fund investments. The report is also to include an assessment of the impacts and outcomes of the investments in those areas on economic indicators including job creation, poverty reduction and new business starts, and other metrics as determined by the Secretary.

Effective Dates

The provision is effective on the date of enactment, December 22, 2017.

California Law (R&TC sections 17053.73 and 23626)

California does not conform to the deferral and exclusion of capital gains reinvested or invested in qualified opportunity zone funds under IRC sections 1400Z-1 and 1400Z-2, and has no similar provisions.

California has a tax incentive provision, under the PITL and the CTL, for taxpayers conducting business activities in designated census tracts or economic development areas. The New Employment Credit[1210] is available for each taxable year beginning on or after January 1, 2014, and before January 1, 2021, to qualified taxpayers that hire qualified full-time employees on or after January 1, 2014, and pay or incur qualified wages attributable to work performed by the qualified full-time employee in a designated census tract or economic development area.

Impact on California Revenue

Not applicable.

[1210] R&TC section 17053.73.

Subtitle D—International Tax Provisions

Present Law

Background

The following discussion provides an overview of general principles of taxation of cross-border activity as well as a detailed explanation of provisions in prior law that are relevant to the provisions in the Tax Cuts and Jobs Act of 2017.[1211]

A. General Overview of International Principles of Taxation

International law generally recognizes the right of each sovereign nation to prescribe rules to regulate conduct with a sufficient nexus to the sovereign nation. The nexus may be based on nationality of the actor, *i.e.*, a nexus between said conduct and a person (whether natural or juridical) with a connection to the sovereign nation, or it may be territorial, *i.e.*, a nexus between the conduct to be regulated and the territory where the conduct occurs.[1212] For example, most legal systems respect limits on the extent to which their measures may be given extraterritorial effect. The broad acceptance of such norms extends to authority to regulate cross-border trade and economic dealings, including taxation.

The exercise of sovereign jurisdiction is usually based on either nationality of the person whose conduct is regulated or the territory in which the conduct or activity occurs. These concepts have been refined and, in varying combinations, adapted to form the principles for determining whether sufficient nexus with a jurisdiction exists to conclude that the jurisdiction may enforce its right to impose a tax. The elements of nexus and the nomenclature of the principles may differ based on the type of tax in question. Taxes are categorized as either direct taxes or indirect taxes. The former category generally refers to those taxes that are imposed directly on a person (capitation tax), property, or income from property and that cannot be shifted to another person by the taxpayer. In contrast, indirect taxes are taxes on consumption or production of goods or services, for which a taxpayer may shift responsibility to another person. Such taxes include sales or use taxes, value-added taxes, or customs duties.[1213]

Although governments have imposed direct taxes on property and indirect taxes and duties on specific transactions since ancient times, the history of direct taxes in the form of an income tax is relatively recent.[1214] When determining how to allocate the right to tax a particular item of

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[1211] An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018.

[1212] American Law Institute, *Restatement (Third) of Foreign Relations Law of the United States*, sections 402 and 403, (1987).

[1213] Maria S. Cox, Fritz Neumark, et al., "Taxation" *Encyclopedia Britannica*, https://www.britannica.com/topic/taxation/Classes-of-taxes, accessed May 16, 2017. Whether a tax is considered a direct tax or indirect tax has varied over time, and no single definition is used. For a review of the significance of these terms in Federal tax history, see Alan O. Dixler, "Direct Taxes Under the Constitution: A Review of the Precedents," *Tax History Project, Tax Analysts*, available at *http://www.taxhistory.org/thp/readings.nsf/ArtWeb/2B34C7FBDA41D9DA852573080067017?OpenDocument*, accessed May 17, 2017.

[1214] The earliest western income tax system is traceable to the British Tax Act of 1798, enacted in 1799 to raise income, most jurisdictions consider principles based on either source (territory or situs of the income) or residence (nationality of the taxpayer).[1215] By contrast, when the authority to collect indirect taxes in the form of sales taxes or value added taxes (VATs) is under consideration, jurisdictions analyze the taxing rights in terms of the origin principle or destination principle. The balance of this General Overview discussion describes the principles in more detail and how jurisdictions resolve claims of overlapping jurisdiction.

1. Origin and Destination Principles

Indirect taxes that are imposed based on the place where production of goods or services occur, irrespective of the location of the persons who own the means of production, and where the goods and services go after being produced, are examples of origin-based taxes. If, instead, authority to tax a transaction or service is dependent on the location of use or consumption of the goods or services, the tax system is an example of a destination-based tax. The most common form of a destination-based tax is the destination-based VAT. Over 160 countries have adopted a VAT,[1216] which is generally a tax imposed and collected on the "value added" at every stage in the production and distribution of a good or service. Although there are several ways to compute the taxable base for a VAT, the amount of value added can generally be thought of as the difference between the value of sales (outputs) and purchases (inputs) of a business.[1217] The United States does not have a VAT, nor is there a federal sales or use tax. However, the majority of the states have enacted sales or use taxes, including both origin-based taxes and destination-based taxes.[1218]

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funds needed to prosecute the Napoleonic Wars, and rescinded in 1816. See, A.M. Bardopoulos, *eCommerce and the Effects of Technology on Taxation*, Law, Governance and Technology Series 22, DOI 10.1007/978-3-319-15449-7_2, (Springer 2015), at Section 2.2. "History of Tax," pp. 23-24. See also, *http:llwww.parliament.uklaboutlliving-heritageltransformingsociety/private-lives/taxation/overview/incometax/*.

[1215] Reuven Avi-Yonah, "International Tax as International Law," 57 *Tax Law Review* 483 (2003-2004).

[1216] Alan Schenk, Victor Thuronyi, and Wei Cui, *Value Added Tax: A Comparative Approach*, Cambridge University Press, 2015. Consistent with the OECD *International VAT/GST Guidelines*, *supra*, the term VAT is used to refer to all broad-based final consumption taxes, regardless of the acronym used to identify. Thus, many countries that denominate their national consumption tax as a GST (general sales tax) are included in the estimate of the number of countries with a VAT.

[1217] Nearly all countries use the credit-invoice method of calculating value added to determine VAT liability. Under the credit-invoice method, a tax is imposed on the seller for all of its sales. The tax is calculated by applying the tax rate to the sales price of the good or service, and the amount of tax is generally disclosed on the sales invoice. A business credit is provided for all VAT levied on purchases of taxable goods and services (*i.e.*, "inputs") used in the seller's business. The ultimate consumer (*i.e.*, a non-business purchaser), however, does not receive a credit with respect to his or her purchases. The VAT credit for inputs prevents the imposition of multiple layers of tax with respect to the total final purchase price (*i.e.*, a ''cascading'' of the VAT). As a result, the net tax paid at a particular stage of production or distribution is based on the value added by that taxpayer at that stage of production or distribution. In theory, the total amount of tax paid with respect to a good or service from all levels of production and distribution should equal the sales price of the good or service to the ultimate consumer multiplied by the VAT rate. In order to receive an input credit with respect to any purchase, a business purchaser is generally required to possess an invoice from a seller that contains the name of the purchaser and indicates the amount of tax collected by the seller on the sale of the input to the purchaser. At the end of a reporting period, a taxpayer may calculate its tax liability by subtracting the cumulative amount of tax stated on its purchase invoices from the cumulative amount of tax stated on its sales invoices.

[1218] EY, *Worldwide VAT, GST and Sales Tax Guide 2015*, p. 1021, available at *http://www.ey.com/Publication/vwLUAssets/Worldwide-VAT-GST-and-sales-tax-guide-2015/$FILE/ Worldwide%20VAT,%20GST%20 and%20Sales%20Tax%20 Guide%202015.pdf*.renee

With respect to cross-border transactions, the Organization for Economic Cooperation and Development (OECD) has recommended that the destination principle be adopted for all indirect taxes, in part to conform to the treatment of such transactions for purposes of customs duties. The OECD defines the destination principle as "the principle whereby, for consumption tax purposes, internationally traded services and intangibles should be taxed according to the rules of the jurisdiction of consumption."[1219] A jurisdiction may determine the place of use or consumption by adopting the convention that the place of business or residence of a customer is the place of consumption. Use of such proxies are needed to determine the location of businesses that are juridical entities, which are more able than natural persons to move the location of use of goods, services or intangibles in response to imposition of tax.

2. Source and Residence Principles

Exercise of taxing authority based on a person's residence may be based on status as a national, resident, or domiciliary of a jurisdiction and may reach worldwide activities of such persons. As such, it is the broadest assertion of taxing authority. For individuals, the test for residence may depend upon nationality, or a physical presence test, or some combination of the two. For all other persons, determining residency may require more complex consideration of the level of activities within a jurisdiction, management, control or place of incorporation. Such rules generally reflect a policy decision about the requisite level of activity within, or contact with, a jurisdiction by a person that is sufficient to warrant assertion of taxing jurisdiction.

Source-based exercise of taxing authority taxes income from activities that occur, or property that is located, within the territory of the taxing jurisdiction. If a person conducts business or owns property in a jurisdiction, or if a transaction occurs in whole or in part in a jurisdiction, the resulting taxation may require allocation and apportionment of expenses attributable to the activity in order to ensure that only the portion of profits that have the required nexus with the territory are subject to tax. Most jurisdictions, including the United States, have rules for determining the source of items of income and expense in a broad range of categories such as compensation for services, dividends, interest, royalties and gains.

Regardless of which of these two bases of taxing authority is chosen by a jurisdiction, a jurisdiction's determination of whether a transaction, activity or person is subject to tax requires that the jurisdiction establish the limits on its assertion of authority to tax.

3. Resolving Overlapping or Conflicting Jurisdiction to Tax

Countries have developed norms about what constitutes a reasonable regulatory action by a sovereign state that will be respected by other sovereign states. Consensus on what constitutes a reasonable limit on the extent of one state's jurisdiction helps to minimize the risk of conflicts arising as a result of extraterritorial action by a state or overlapping exercise of authority by states. Mechanisms to eliminate double taxation have developed to address those situations in which the source and residency determinations of the respective jurisdictions result in duplicative assertion

[1219] See, OECD, "Recommendation of the Council on the application of value added tax/goods and services tax to the international trade in services and intangibles as approved on September 27, 2016," [C(2016)120], appendix, page 3, reproduced in the appendix, OECD, *International VAT/GST Guidelines*, OECD Publishing, 2017.

of taxing authority. For example, asymmetry between different standards adopted in two countries for determining residency of persons, source of income, or other basis for taxation may result in income that is subject to taxation in both jurisdictions.

When the rules of two or more countries overlap, potential double taxation is usually mitigated by operation of bilateral tax treaties or by legislative measures permitting credit for taxes paid to another jurisdiction. The United States is a partner in numerous bilateral agreements that have as their objective the avoidance of international double taxation and the prevention of tax avoidance and evasion. Another related objective of U.S. tax treaties is the removal of the barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal. The United States Model Income Tax Convention (U.S. Model Treaty of 2016) with an accompanying Preamble by the Department of Treasury, reflects the most recent comprehensive statement of U.S. negotiating position with respect to tax treaties.[1220] Bilateral agreements are also used to permit limited mutual administrative assistance between jurisdictions.[1221]

In addition to entering into bilateral treaties, countries have worked in multilateral organizations to develop common principles to alleviate double taxation. Those principles are generally reflected in the provisions of the Model Tax Convention on Income and on Capital of the Organization for Economic Cooperation and Development (the OECD Model treaty),[1222] a precursor of which was first developed by a predecessor organization in 1958, which in turn has antecedents from work by the League of Nations in the 1920s.[1223] As a consensus document, the OECD Model treaty is intended to serve as a model for countries to use in negotiating a bilateral treaty that would settle issues of double taxation as well as to avoid inappropriate double nontaxation. The provisions have developed over time as practice with actual bilateral treaties leads to unexpected results and new issues are raised by parties to the treaties.[1224]

[1220] The current U.S. Model treaty was published February 17, 2016, and is available at *https://www.treasury.gov/ resource-center/ tax-policy/ treaties/ Documents/Treaty-US%20Model-2016.pdf*; the Preamble is available at *https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Preamble-US%20Model-2016.pdf*. The U.S. Model treaty is updated periodically to reflect developments in the negotiating position of the United States. Such changes include provisions that were successfully included in bilateral treaties concluded by the United States, as well as new proposed measures not yet included in a bilateral agreement.

[1221] Although U.S. courts extend comity to foreign judgments in some instances, they are not required to recognize or assist in enforcement of foreign judgments for collection of taxes, consistent with the common law "revenue rule" in *Holman v. Johnson*, 1 Cowp. 341, 98 Eng. Rep. 1120 (K.B.1775). American Law Institute, *Restatement (Third) of Foreign Relations Law of the United States*, section 483, (1987). The rule retains vitality in U.S. case law. *Pasquantino v. United States*, 544 U.S. 349; 125 S. Ct. 1766; 161 L. Ed. 2d 619 (2005) (a conviction for criminal wire fraud arising from an intent to defraud Canadian tax authorities was found not to conflict "with any well-established revenue rule principle[,]" and thus was not in derogation of the revenue rule). To the extent it is abrogated, it is done so in bilateral treaties, to ensure reciprocity. At present, the United States has such agreements in force with five jurisdictions: Canada; Denmark; France; Netherlands; and Sweden.

[1222] OECD (2014), Model Tax Convention on Income and on Capital: Condensed Version 2014, OECD Publishing, 2014, available at *http://dx.doi.org/10.1787//mtc*_cond-2014-en. The multinational organization was first established in 1961 by the United States, Canada and 18 European countries, dedicated to global development, and has since expanded to 35 members.

[1223] "Report by the Experts on Double Taxation," League of Nation Document E.F.S. 73/F19 (1923), a report commissioned by the League at its second assembly. See also, Lara Friedlander and Scott Wilkie, "Policy Forum: The History of Tax Treaty Provisions And Why It Is Important to Know About It," 54 *Canadian Tax Journal* No. 4 (2006).

[1224] For example, the OECD initiated a multi-year study on base-erosion and profit shifting in response to concerns of

4. International Principles as Applied in the U.S. System

Prior law combines taxation of all U.S. persons on their worldwide income, whether derived in the United States or abroad, with limited deferral of taxation of income earned by foreign subsidiaries of U.S. companies and source-based taxation of the U.S.-source income of nonresident aliens and foreign entities. Under this system (sometimes described as the U.S. hybrid system), the application of the Internal Revenue Code (IRC) differs depending on whether income arises from outbound investment or inbound investment. Outbound investment refers to the foreign activities of U.S. persons, while inbound investment is investment by foreign persons in U.S. assets or activities, although certain rules are common to both inbound and outbound activities.

B. Principles Common to Inbound and Outbound Taxation

Although the U.S. tax rules differ depending on whether the activity in question is inbound or outbound, there are certain concepts that apply to both inbound and outbound investment. Such areas include the transfer pricing rules, entity classification, the rules for determination of source, and whether a corporation is foreign or domestic.

1. Residence

U.S. persons are subject to tax on their worldwide income. The IRC defines U.S. person to include all U.S. citizens and residents as well as domestic entities such as partnerships, corporations, estates and certain trusts.[1225] The term "resident" is defined only with respect to natural persons. Noncitizens who are lawfully admitted as permanent residents of the United States in accordance with immigration laws (colloquially referred to as green card holders) are treated as residents for tax purposes. In addition, noncitizens who meet a substantial presence test and are not otherwise exempt from U.S. taxation are also taxable as U.S. residents.[1226]

For legal entities, the IRC determines whether an entity is subject to U.S. taxation on its worldwide income on the basis of its place of organization. For purposes of U.S. tax law, a corporation or partnership is treated as domestic if it is organized or created under the laws of the United States or of any State, unless, in the case of a partnership, the Secretary prescribes otherwise by regulation.[1227] All other partnerships and corporations (that is, those organized under the laws of foreign countries) are treated as foreign.[1228] In contrast, place of organization is not determinative of residence under taxing jurisdictions that use factors such as situs, management and control to determine residence. As a result, legal entities may have more than one tax residence, or, in some case, no residence.[1229] Only domestic corporations are subject to U.S. tax

multiple members. For an overview of that project, see Joint Committee on Taxation, *Background, Summary, and Implications of the OECD/G20 Base Erosion and Profit Shifting Project* (JCX-139-15), November 30, 2015. This document can also be found on the Joint Committee on Taxation website at *www.jct.gov*.

[1225] IRC section 7701(a)(30).

[1226] IRC section 7701(b).

[1227] IRC section 7701(a)(4).

[1228] IRC sections 7701(a)(5) and 7701(a)(9). Entities organized in a possession or territory of the United States are not considered to have been organized under the laws of the United States.

[1229] "The notion of corporate residence is an important touchstone of taxation, however, in many foreign income tax on a worldwide basis. Foreign corporations are taxed only on income that has a sufficient connection with the United States.

Tax benefits otherwise available to a domestic corporation that migrates its tax home from the United States to a foreign jurisdiction may be denied to such corporation, in which case it continues to be treated as a domestic corporation for ten years following such migration.[1230] These sanctions generally apply to a transaction in which, pursuant to a plan or a series of related transactions: (1) a domestic corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity in a transaction completed after March 4, 2003; (2) the former shareholders of the domestic corporation hold (by reason of the stock they had held in the domestic corporation) at least 60 percent but less than 80 percent (by vote or value) of the stock of the foreign-incorporated entity after the transaction (this stock often being referred to as "stock held by reason of"); and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50 percent ownership (that is, the "expanded affiliated group"), does not have substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group.[1231]

The Treasury Department and the Internal Revenue Service (IRS) have promulgated detailed guidance, through both regulations and several notices, addressing these requirements under IRC section 7874 since the section was enacted in 2004,[1232] and have sought to expand the reach of the section or reduce the tax benefits of inversion transactions. For example, Notice 2014-52 announced Treasury's and the IRS's intention to issue regulations and took a two-pronged approach. First, it addressed the treatment of cross-border combination transactions themselves. Second, it addressed post-transaction steps that taxpayers may undertake with respect to U.S.-owned foreign subsidiaries making it more difficult to access foreign earnings without incurring added U.S. tax. On November 19, 2015, Treasury and the IRS issued Notice 2015-79, which announced their intent to issue further regulations to limit cross-border merger transactions, expanding on the guidance issued in Notice 2014-52. In 2016, Treasury and the IRS issued proposed and temporary regulations that incorporate the rules previously announced in Notice 2014-52 and Notice 2015-79 and a new multiple domestic entity acquisition rule.[1233]

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systems[,]'" with the result that the bilateral treaties are often relied upon to resolve conflicting claims of taxing jurisdiction. Joseph Isenbergh, Vol. 1 *U.S. Taxation of Foreign Persons and Foreign Income*, Para. 7.1 (Fourth Ed. 2016).

[1230] IRC section 7874.

[1231] IRC section 7874(a). In addition, an excise tax may be imposed on certain stock compensation of executives of companies that undertake inversion transactions. IRC section 4985.

[1232] Notice 2015-79, 2015 I.R.B. LEXIS 583 (Nov. 19, 2015), which announced their intent to issue further regulations to limit cross-border merger transactions, expanding on the guidance issued in Notice 2014-52. On April 4, 2016, Treasury and the IRS issued proposed and temporary regulations (T.D. 9761) that incorporate the rules previously announced in Notice 201452 and Notice 2015-79 and a new multiple domestic entity acquisition rule. On January 13, 2017, Treasury and the IRS issued final and temporary regulations under IRC section 7874 (T.D. 9812), which adopt, with few changes, prior temporary and proposed regulations, which identify certain stock of an acquiring foreign corporation that is disregarded in calculating the ownership of the foreign corporation for purposes of IRC section 7874.

[1233] T.D. 9761, April 4, 2016. But see, *Chamber of Commerce v Internal Revenue Service*, Cause No 1:16-CV-944-LY (W.D. Tex. Sept. 29, 2017), granting summary judgment to plaintiff in challenge to temporary regulations based on lack of compliance with Administrative Procedure Requirements.

In early 2017, Treasury issued final and temporary regulations[1234] that adopt, with few changes, the 2016 temporary and proposed regulations.

2. Entity Classification

Certain entities are eligible to elect their classification for federal tax purposes under the "check-the-box" regulations adopted in 1997.[1235] Those regulations simplified the entity classification process for both taxpayers and the IRS by making the entity classification of unincorporated entities explicitly elective in most instances.[1236] The eligibility to elect and the breadth of an entity's choices depend upon whether it is a "per se corporation" and its number of beneficial owners. Foreign as well as domestic entities may make the election. As a result, it is possible for an entity that operates across countries to be treated as a hybrid entity. A hybrid entity is one which is treated as a flow-through or disregarded entity for U.S. tax purposes but as a corporation for foreign tax purposes. For "reverse hybrid entities," the opposite is true. The election can affect the determination of the source of the income, availability of tax credits, and other tax attributes.

3. Source of Income Rules

The rules for determining the source of certain types of income are specified in the IRC and described briefly below. Various factors determine the source of income for U.S. tax purposes, including the status or nationality of the payor, the status or nationality of the recipient, the location of the recipient's activities that generate the income, and the location of the assets that generate the income. To the extent that the source of income is not specified by statute, the Treasury Secretary may promulgate regulations that explain the appropriate treatment. However, many items of income are not explicitly addressed by either the IRC or Treasury regulations, sometimes resulting in nontaxation of the income. On several occasions, courts have determined the source of such items by applying the rule for the type of income to which the disputed income is most closely analogous, based on all facts and circumstances.[1237]

Interest

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

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[1234] T.D. 9812, January 13, 2017.
[1235] Treasury Regulation section 301.7701-1, *et seq.*
[1236] The check-the-box regulations replaced Treasury Regulation section 301.7701-2, as in effect prior to 1997, under which the classification of unincorporated entities for Federal tax purposes was determined on the basis of a four characteristics indicative of status as a corporation: continuity of life, centralization of management, limited liability, and free transferability of interests. An entity that possessed three or more of these characteristics was treated as a corporation; if it possessed two or fewer, then it was treated as a partnership. Thus, to achieve characterization as a partnership under this system, taxpayers needed to arrange the governing instruments of an entity in such a way as to eliminate two of these corporate characteristics. The advent and proliferation of limited liability companies (LLCs) under State laws allowed business owners to create customized entities that possessed a critical common feature limited liability for investors as well as other corporate characteristics the owners found desirable. As a consequence, classification was effectively elective for well-advised taxpayers.
[1237] See, *e.g., Hunt v. Commissioner*, 90 T.C. 1289 (1988).

note, or other interest-bearing obligation.[1238] Special rules apply to treat as foreign-source certain amounts paid on deposits with foreign commercial banking branches of U.S. corporations or partnerships and certain other amounts paid by foreign branches of domestic financial institutions.[1239] Interest paid by the U.S. branch of a foreign corporation is also treated as U.S.-source income.[1240]

Dividends

Dividend income is generally sourced by reference to the payor's place of incorporation.[1241] Thus, dividends paid by a domestic corporation are generally treated as entirely U.S.-source income. Similarly, dividends paid by a foreign corporation are generally treated as entirely foreign-source income. Under a special rule, dividends from certain foreign corporations that conduct U.S. businesses are treated in part as U.S.-source income.[1242]

Rents and Royalties

Rental income is sourced by reference to the location or place of use of the leased property.[1243] The nationality or the country of residence of the lessor or lessee does not affect the source of rental income. Rental income from property located or used in the United States (or from any interest in such property) is U.S.-source income, regardless of whether the property is real or personal, intangible or tangible.

Royalties are sourced in the place of use of (or the place of privilege to use) the property for which the royalties are paid.[1244] This source rule applies to royalties for the use of either tangible or intangible property, including patents, copyrights, secret processes, formulas, goodwill, trademarks, trade names, and franchises.

Income from Sales of Personal Property

Subject to significant exceptions, income from the sale of personal property is sourced on the basis of the residence of the seller.[1245] For this purpose, special definitions of the terms "U.S. resident" and "nonresident" are provided. A nonresident is defined as any person who is not a U.S. resident,[1246] while the term "U.S. resident" comprises any juridical entity which is a U.S. person, all U.S. citizens, as well as any individual who is a U.S. resident without a tax home in a

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[1238] IRC section 861(a)(1); Treasury Regulation section 1.861-2(a)(1).
[1239] IRC sections 861(a)(1) and 862(a)(1). For purposes of certain reporting and withholding obligations the source rule in IRC section 861(a)(1)(B) does not apply to interest paid by the foreign branch of a domestic financial institution. This results in the payment being treated as a withholdable payment. IRC section 1473(1)(C).
[1240] IRC section 884(f)(1).
[1241] IRC sections 861(a)(2), 862(a)(2).
[1242] IRC section 861(a)(2)(B).
[1243] IRC section 861(a)(4).
[1244] *Ibid*.
[1245] IRC section 865(a).
[1246] IRC section 865(g)(1)(B).

foreign country or a nonresident alien with a tax home in the United States.[1247] As a result, nonresident includes any foreign corporation.[1248]

Several special rules apply. For example, income from the sale of inventory property is generally sourced to the place of sale, which is determined by where title to the property passes.[1249] However, if the sale is by a nonresident and is attributable to an office or other fixed place of business in the United States, the sale is treated as income from U.S. sources without regard to the place of sale, unless it is sold for use, disposition, or consumption outside the United States and a foreign office materially participates in the sale.[1250] Income from the sale of inventory property that a taxpayer produces (in whole or in part) in the United States and sells outside the United States, or that a taxpayer produces (in whole or in part) outside the United States and sells in the United States, is treated as partly U.S.-source and partly foreign-source.[1251]

In determining the source of gain or loss from the sale or exchange of an interest in a foreign partnership, the IRS has taken the position that to the extent that there is unrealized gain attributable to partnership assets that are effectively connected with the U.S. business, the foreign person's gain or loss from the sale or exchange of a partnership interest is effectively connected gain or loss to the extent of the partner's distributive share of such unrealized gain or loss, and not capital gain or loss. Similarly, to the extent that the partner's distributive share of unrealized gain is attributable to a permanent establishment of the partnership under an applicable treaty provision, it may be subject to U.S. tax under a treaty.[1252]

Gain on the sale of depreciable property is divided between U.S.-source and foreign-source in the same ratio that the depreciation was previously deductible for U.S. tax purposes.[1253] Payments received on sales of intangible property are sourced in the same manner as royalties to the extent the payments are contingent on the productivity, use, or disposition of the intangible property.[1254]

[1247] IRC section 865(g)(1)(A).
[1248] IRC section 865(g).
[1249] IRC sections 865(b), 861(a)(6), 862(a)(6); Treasury Regulation section 1.861-7(c).
[1250] IRC section 865(e)(2).
[1251] IRC section 863(b). A taxpayer may elect one of three methods for allocating and apportioning income as U.S.-or foreign-source: (1) the 50-50 method under which 50 percent of the income from the sale of inventory property in such a situation is attributable to the production activities and 50 percent to the sales activities, with the income sourced based on the location of those activities; (2) independent factory price ("IFP") method under which, in certain circumstances, an IFP may be established by the taxpayer to determine income from production activities; (3) the books and records method under which, with advance permission, the taxpayer may use books of account to detail the allocation of receipts and expenditures between production and sales activities. Treasury Regulation section 1.863-3(b), (c). If production activity occurs only within the United States, or only within foreign countries, then all income is sourced to where the production activity occurs; when production activities occur in both the United States and one or more foreign countries, the income attributable to production activities must be split between U.S. and foreign sources. Treasury Regulation section 1.863-3(c)(1). The sales activity is generally sourced based on where title to the property passes. Treasury Regulations sections 1.863-3(c)(2), 1.861-7(c).
[1252] Rev. Rul. 91-32, 1991-1 C.B. 107. But see, *Grecian Magnesite Mining, Industrial Shipping Co. SA v Commissioner*, 149 T.C. No. 3 (2017).
[1253] IRC section 865(c).
[1254] IRC section 865(d).

Personal Services Income

Compensation for labor or personal services is generally sourced to the place-of-performance. Thus, compensation for labor or personal services performed in the United States generally is treated as U.S.-source income, subject to an exception for amounts that meet certain *de minimis* criteria.[1255] Compensation for services performed both within and without the United States is allocated between U.S.-and foreign-source.[1256]

Insurance Income

Underwriting income from issuing insurance or annuity contracts generally is treated as U.S.-source income if the contract involves property in, liability arising out of an activity in, or the lives or health of residents of, the United States.[1257]

Transportation Income

Transportation income is any income derived from, or in connection with, the use (or hiring or leasing for use) of a vessel or aircraft (or a container used in connection therewith) or the performance of services directly related to such use.[1258] That definition does not encompass land transport except to the extent that it is directly related to shipping by vessel or aircraft, but regulations extend a similar rule for determining the source of income from transportation services other than shipping or aviation. Source rules generally provide that income from furnishing transportation that both begins and ends in the United States is U.S.-source income,[1259] and 50-percent of income attributable to transportation that either begins or the ends in the United States is treated as U.S.-source income. However, to the extent that the operator of a shipping or cruise line is foreign, its ownership structure and the maritime law[1260] applicable for determining what constitutes international shipping as well as specific income tax provisions combine to create an industry-specific departure from the rules generally applicable.[1261]

[1255] IRC section 861(a)(3). Gross income of a nonresident alien individual, who is present in the United States as a member of the regular crew of a foreign vessel, from the performance of personal services in connection with the international operation of a ship is generally treated as foreign-source income.
[1256] Treasury Regulation section 1.861-4(b).
[1257] IRC section 861(a)(7).
[1258] IRC section 863(c)(3).
[1259] IRC section 863(c).
[1260] U.S. law on navigation is codified in U.S. Code at title 33, and is consistent with the body of international maritime law. The normative principles of international maritime law for determining the maritime zones and territorial sovereignty over seas are embodied in the United Nations Convention on the Law of the Sea, first opened for signature in 1982. Since 1983, the Executive Branch has agreed that the treaty is generally consistent with existing international norms of the law of the sea and that the United States would act in conformity to the principles of the treaty other than those portions regarding deep seabed exploitation, even in the absence of ratification of the treaty.
[1261] Due to the regulatory framework for aviation, an international flight must either originate or conclude in the country of residence of the airline's owner, where income tax for the international flight is assessed. In contrast to international shipping, international aviation cannot be carried out using flags-of-convenience. Thus, although tax law treats shipping and aviation similarly, the differences between the two industries and the applicable regulatory regimes produce different tax outcomes. Full territorial sovereignty applies within 12 nautical miles of one's coast; the contiguous waters beyond 12 nautical miles but up to 24 nautical miles are subject to some regulation. Within 200 nautical miles, a country may assert an economic zone for exploitation of living marine resources and some minerals. Beyond 200 nautical miles are the "high seas" in which no sovereign state may assert exclusive jurisdiction.

A subcategory of transportation income, "U.S. source gross transportation income" is subject to taxation on a gross basis at the rate of four percent.[1262] Income is within the scope of this special tax if it is considered to be U.S. source because travel begins or ends in the United States, is not effectively connected, and is not of a kind to which the exemption from tax applies.[1263]

An exemption from U.S. tax is provided for transportation income of foreign persons from countries that extend reciprocal relief to U.S. persons. A nonresident alien individual with income from the international operation of a ship may qualify, provided that the foreign country in which such individual is resident grants an equivalent exemption to individual residents of the United States.[1264] A similar exemption from U.S. tax is provided for gross income derived by a foreign corporation from the international operation of an aircraft, provided that the foreign country in which the corporation is organized grants an equivalent exemption to corporations organized in the United States.[1265] To determine whether income from shipping or aviation is eligible for an exemption under IRC section 883, one must examine the extent to which the foreign jurisdiction has extended reciprocity for U.S. businesses; whether the party claiming an exemption is eligible for the tax relief; and the nature of the activities that give rise to the income.

Income from Space or Ocean Activities or International Communications

In the case of a foreign person, generally no income from a space or ocean activity or from international communications is treated as U.S.-source income.[1266] With respect to the latter, an exception is provided if the foreign person maintains an office or other fixed place of business in the United States, in which case the international communications income attributable to such fixed place of business is treated as U.S.-source income.[1267] For U.S. persons, all income from space or ocean activities and 50 percent of income from international communications is treated as U.S.-source income.

Amounts Received with Respect to Guarantees of Indebtedness

Amounts received, directly or indirectly, from a noncorporate resident or from a domestic corporation for the provision of a guarantee of indebtedness of such person are income from U.S. sources.[1268] This includes payments that are made indirectly for the provision of a guarantee. For example, U.S.-source income under this rule includes a guarantee fee paid by a foreign bank to a foreign corporation for the foreign corporation's guarantee of indebtedness owed to the bank

[1262] IRC section 887(a). Special rules for determining whether transportation income is effectively connected with the conduct of a U.S. trade or business are also provided, and for coordinating the application of IRC sections 871, 882, and 887.
[1263] IRC section 887(b)(1).
[1264] IRC section 872(b)(1).
[1265] IRC section 883(a)(2).
[1266] IRC section 863(d).
[1267] IRC section 863(e).
[1268] IRC section 861(a)(9). This provision effects a legislative override of the opinion in *Container Corp.* v. *Commissioner,* 134 T.C. 122 (February 17, 2010), aff'd 2011 WL1664358, 107 A.F.T.R.2d 2011-1831 (5th Cir. May 2, 2011), in which the Tax Court held that fees paid by a domestic corporation to its foreign parent with respect to guarantees issued by the parent for the debts of the domestic corporation were more closely analogous to compensation for services than to interest, and determined that the source of the fees should be determined by reference to the residence of the foreign parent-guarantor. As a result, the income was treated as income from foreign sources.

by the foreign corporation's domestic subsidiary, where the cost of the guarantee fee is passed on to the domestic subsidiary through, for instance, additional interest charged on the indebtedness. In this situation, the domestic subsidiary has paid the guarantee fee as an economic matter through higher interest costs, and the additional interest payments made by the subsidiary are treated as indirect payments of the guarantee fee and, therefore, as income from U.S. sources.

Such U.S.-source income also includes amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of indebtedness of that foreign person if the payments received are connected with income of such person that is effectively connected with the conduct of a U.S. trade or business. Amounts received from a foreign person, whether directly or indirectly, for the provision of a guarantee of that person's debt, are treated as foreign-source income if they are not from sources within the United States under IRC section 861(a)(9).

4. Intercompany Transfers

Transfer Pricing

A basic U.S. tax principle applicable in dividing profits from transactions between related taxpayers is that the amount of profit allocated to each related taxpayer must be measured by reference to the amount of profit that a similarly situated taxpayer would realize in similar transactions with unrelated parties. The transfer pricing rules of IRC section 482 and the accompanying Treasury regulations are intended to preserve the U.S. tax base by ensuring that taxpayers do not shift income properly attributable to the United States to a related foreign company through pricing that does not reflect an arm's-length result.[1269] Similarly, the domestic laws of most U.S. trading partners include rules to limit income shifting through transfer pricing. The arm's-length standard is difficult to administer in situations in which no unrelated party market prices exist for transactions between related parties. When a foreign person with U.S. activities has transactions with related U.S. taxpayers, the amount of income attributable to U.S. activities is determined in part by the same transfer pricing rules of IRC section 482 that apply when U.S. persons with foreign activities transact with related foreign taxpayers.

IRC section 482 authorizes the Secretary of the Treasury to allocate income, deductions, credits, or allowances among related business entities[1270] when necessary to clearly reflect income or otherwise prevent tax avoidance, and comprehensive Treasury regulations under that section adopt the arm's-length standard as the method for determining whether allocations are appropriate.[1271]

The regulations generally attempt to identify the respective amounts of taxable income of the related parties that would have resulted if the parties had been unrelated parties dealing at arm's

[1269] For a detailed description of the U.S. transfer pricing rules, see Joint Committee on Taxation, *Present Law and Background Related to Possible Income Shifting and Transfer Pricing* (JCX-37-10), July 20, 2010, pp. 18-50.
[1270] The term "related" as used herein refers to relationships described in IRC section 482, which refers to "two or more organizations, trades or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests."
[1271] IRC section 1059A buttresses IRC section 482 by limiting the extent to which costs used to determine custom valuation can also be used to determine basis in property imported from a related party. A taxpayer that imports property from a related party may not assign a value to the property for cost purposes that exceeds its customs value.

length. For income from intangible property, IRC section 482 provides "in the case of any transfer (or license) of intangible property (within the meaning of IRC section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible." By requiring inclusion in income of amounts commensurate with the income attributable to the intangible, Congress was responding to concerns regarding the effectiveness of the arm's-length standard with respect to intangible property including, in particular, high-profit-potential intangibles.[1272]

Gain Recognition on Outbound Transfers

If a transfer of intangible property to a foreign affiliate occurs in connection with certain corporate transactions, nonrecognition rules that may otherwise apply are suspended. The transferor of intangible property must recognize gain from the transfer as though he had sold the intangible (regardless of the stage of development of the intangible property) in exchange for payments contingent on the use, productivity or disposition of the transferred property in amounts that would have been received either annually over the useful life of the property or upon disposition of the property after the transfer.[1273] The appropriate amounts of those imputed payments are determined using transfer-pricing principles. Final regulations issued in 2016 eliminate an exception under temporary regulations that permitted nonrecognition of gain from outbound transfers of foreign goodwill and going concern value. However, the Secretary announced that reinstatement of an exception for active trade or business is under consideration for cases with little potential for abuse and administrative difficulties.[1274]

C. U.S. Tax Rules Applicable to Foreign Activities of U.S. Persons (Outbound)

1. In General

In general, income earned directly by a U.S. person from the conduct of a foreign business is taxed on a current basis,[1275] but income earned indirectly from a separate legal entity operating the foreign business is not. Instead, active foreign business income earned by a U.S. person indirectly through an interest in a foreign corporation generally is not subject to U.S. tax until the income is distributed as a dividend to the U.S. person. Certain anti-deferral regimes may cause the U.S. owner to be taxed on a current basis in the United States on certain categories of passive or highly mobile income earned by the foreign corporation regardless of whether the income has been

[1272] H.R. Rep. No. 99-426, p. 423.
[1273] IRC section 367(d).
[1274] See, T.D. 9803, 81 F.R. 91012 (December 17, 2016). Treasury Regulation section 1.367(d)-1(b) now provides that the rules of IRC section 367(d) apply to transfers of intangible property as defined under Treasury Regulation sections 1.367(a)-1(d)(5) after September 14, 2015, and to any transfers occurring before that date resulting from entity classification elections filed on or after September 15, 2015. Noting that commenters on the regulations had cited legislative history that contemplated active business exceptions, Treasury announced the reconsideration of the rule. U.S. Treasury Department, *Second Report to the President on Identifying and Reducing Tax Regulatory Burdens, Executive Order 13789* October 2, 2017, TNT Doc 2017-72131. The relevant legislative history is found at in H.R. Rep. No. 98-432, 98th Cong., 2d Sess. 1318-1320 (March 5, 1984) and Conference Report, H.R. Rep. No. 98-861, 98th Cong. 2d Sess. 951-957 (June 23, 1984).
[1275] A U.S. citizen or resident living abroad may be eligible to exclude from U.S. taxable income certain foreign earned income and foreign housing costs under IRC section 911. For a description of this exclusion, *see Present Law and Issues in U.S. Taxation of Cross-Border Income* (JCX-42-11), September 6, 2011, p. 52.

distributed as a dividend to the U.S. owner. The main anti-deferral regimes that provide such exceptions are the controlled foreign corporation (CFC) rules of subpart F[1276] and the passive foreign investment company (PFIC) rules.[1277] A foreign tax credit generally is available to offset, in whole or in part, the U.S. tax owed on foreign-source income, whether the income is earned directly by the domestic corporation, repatriated as an actual dividend, or included in the domestic parent corporation's income under one of the anti-deferral regimes.[1278]

2. Anti-deferral regimes

Subpart F

Subpart F,[1279] applicable to CFCs and their shareholders, is the main anti-deferral regime of relevance to a U.S.-based multinational corporate group. A CFC generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50 percent of the corporation's stock (measured by vote or value), taking into account only those U.S. persons that are within the meaning of the term "United States shareholder," which refers only to those U.S. persons who own at least 10 percent of the stock (measured by vote only).[1280]

Subpart F Income

Under the subpart F rules, the United States generally taxes the 10-percent U.S. shareholders of a CFC on their pro rata shares of certain income of the CFC (referred to as "subpart F income"), without regard to whether the income is distributed to the shareholders.[1281] In effect, the United States treats the 10-percent U.S. shareholders of a CFC as having received a current distribution of the corporation's subpart F income. With exceptions described below, subpart F income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another. Subpart F income consists of foreign base company income,[1282] insurance income,[1283] and certain income relating to international boycotts and other violations of public policy.[1284]

Foreign base company income consists of foreign personal holding company income, which includes passive income such as dividends, interest, rents, and royalties, and a number of categories of income from business operations, including foreign base company sales income, foreign base company services income, and foreign base company oil-related income.[1285]

[1276] IRC sections 951-964.
[1277] IRC sections 1291-1298.
[1278] IRC sections 901, 902, 960, 1293(f).
[1279] IRC sections 951-964.
[1280] IRC sections 951(b), 957, 958. The term "United States shareholder" is used interchangeably herein with "U.S. shareholder."
[1281] IRC section 951(a).
[1282] IRC section 954.
[1283] IRC section 953.
[1284] IRC section 952(a)(3)-(5).
[1285] IRC section 954.

Insurance income subject to current inclusion under the subpart F rules includes any income of a CFC attributable to the issuing or reinsuring of any insurance or annuity contract in connection with risks located in a country other than the CFC's country of organization. Subpart F insurance income also includes income attributable to an insurance contract in connection with risks located within the CFC's country of organization as the result of an arrangement under which another corporation receives a substantially equal amount of consideration for insurance of other country risks. Finally, special rules apply under subpart F with respect to related person insurance income[1286] in order to address captive insurance companies.[1287] Under these rules, the threshold for determining control is reduced to 25 percent, and any level of stock ownership by a U.S. person in such corporation is sufficient for the person to be treated as a U.S. shareholder.

Investments in U.S. Property

The 10-percent U.S. shareholders of a CFC also are required to include currently in income for U.S. tax purposes their pro rata shares of the corporation's untaxed earnings invested in certain items of U.S. property.[1288] This U.S. property generally includes tangible property located in the United States, stock of a U.S. corporation, an obligation of a U.S. person, and certain intangible assets, such as patents and copyrights, acquired or developed by the CFC for use in the United States.[1289] There are specific exceptions to the general definition of U.S. property, including for bank deposits, certain export property, and certain trade or business obligations.[1290] The inclusion rule for investment of earnings in U.S. property is intended to prevent taxpayers from avoiding U.S. tax on dividend repatriations by repatriating CFC earnings through non-dividend payments, such as loans to U.S. persons.

Subpart F Exceptions

Several exceptions to the broad definition of subpart F income permit continued deferral for income from certain transactions, dividends, interest and certain rents and royalties received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized.[1291] The same-country exception is not available to the extent that the payments reduce the subpart F income of the payor. A second exception from foreign base company income and insurance income is available for any item of income received by a CFC if the taxpayer establishes that the income was subject to an effective foreign income tax rate greater than 90 percent of the maximum U.S. corporate income tax rate (that is, more than 90 percent of 35 percent, or 31.5 percent).[1292]

[1286] IRC section 953(c). Related person insurance income is defined for this purpose to mean any insurance income attributable to a policy of insurance or reinsurance with respect to which the primary insured is either a U.S. shareholder (within the meaning of the provision) in the foreign corporation receiving the income or a person related to such a shareholder.
[1287] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, p. 968.
[1288] IRC sections 951(a)(1)(B), 956.
[1289] IRC section 956(c)(1).
[1290] IRC section 956(c)(2).
[1291] IRC section 954(c)(3).
[1292] IRC section 954(b)(4).

A provision known as the “CFC look-through” rule excludes from foreign personal holding company income dividends, interest, rents, and royalties received or accrued by one CFC from a related CFC (with relation based on control) to the extent attributable or properly allocable to non-subpart-F income of the payor.[1293] The look-through rule applies to taxable years of foreign corporations beginning before January 1, 2020, and to taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.[1294]

There is also an exclusion from subpart F income for certain income of a CFC that is derived in the active conduct of banking or financing business (active financing income), which applies to all taxable years of the foreign corporation beginning after December 31, 2014, and for taxable years of the shareholders that end during or within such taxable years of the corporation.[1295] With respect to income derived in the active conduct of a banking, financing, or similar business, a CFC is required to be predominantly engaged in such business and to conduct substantial activity with respect to such business in order to qualify for the active financing exceptions. In addition, certain nexus requirements apply, which provide that income derived by a CFC or a qualified business unit (QBU) of a CFC from transactions with customers is eligible for the exceptions if, among other things, substantially all of the activities in connection with such transactions are conducted directly by the CFC or QBU in its home country, and such income is treated as earned by the CFC or QBU in its home country for purposes of such country's tax laws. Moreover, the exceptions apply to income derived from certain cross border transactions, provided that certain requirements are met.

In the case of a securities dealer, an exception from foreign personal holding company income applies to any interest or dividend (or certain equivalent amounts) from any transaction, including a hedging transaction or a transaction consisting of a deposit of collateral or margin, entered into in the ordinary course of the dealer's trade or business as a dealer in securities within the meaning of IRC section 475.[1296] In the case of a QBU of the dealer, the income is required to be attributable to activities of the QBU in the country of incorporation, or to a QBU in the country in which the QBU both maintains its principal office and conducts substantial business activity. A coordination rule provides that, for securities dealers, this exception generally takes precedence over the exception for active financing income.

Income is treated as active financing income only if, among other requirements, it is derived by a CFC or by a QBU of that CFC. Certain activities conducted by persons related to the CFC or its QBU are treated as conducted directly by the CFC or QBU.[1297] An activity qualifies under this rule if the activity is performed by employees of the related person and if the related person is an eligible CFC, the home country of which is the same as the home country of the related CFC or QBU; the

[1293] IRC section 954(c)(6).
[1294] See section 144 of the Protecting Americans from Tax Hikes Act of 2015 (Division Q of Public Law Number 114-113), H.R. 2029 [“the PATH Act of 2015”], which extended IRC section 954(c)(6) for five years. Congress has previously extended the application of IRC section 954(c)(6) several times, most recently in the Tax Increase Prevention Act of 2014, Public Law Number 113-295; Public Law Number 107147, section 614, 2002; Public Law Number 106-170, section 503, 1999; Public Law Number 105-277, 1998.
[1295] IRC section 954(h). See section 128 of the PATH Act of 2015, which made the active financing exception permanent.
[1296] IRC section 954(c)(2)(C).
[1297] IRC section 954(h)(3)(E).

activity is performed in the home country of the related person; and the related person receives arm's-length compensation that is treated as earned in the home country. Income from an activity qualifying under this rule is excluded from subpart F income so long as the other active financing requirements are satisfied.

Certain income of a qualifying branch of a qualifying insurance company with respect to risks located within the home country of the branch or within the CFC's country of creation or organization are also excepted from foreign personal holding company income, provided that certain requirements are met. Further, additional exceptions from insurance income and from foreign personal holding company income apply for certain income of certain CFCs or branches with respect to risks located in a country other than the United States, provided that the requirements for these exceptions, including reserve requirements, are met.[1298]

Exclusion of Previously Taxed Earnings and Profits

A 10-percent U.S. shareholder of a CFC may exclude from its income actual distributions of earnings and profits from the CFC that were previously included in the 10-percent U.S. shareholder's income under subpart F.[1299] Any income inclusion (under IRC section 956) resulting from investments in U.S. property may also be excluded from the 10-percent U.S. shareholder's income when such earnings are ultimately distributed.[1300] Ordering rules provide that distributions from a CFC are treated as coming first out of earnings and profits of the CFC that have been previously taxed under subpart F, then out of other earnings and profits.[1301]

Basis Adjustments

In general, a 10-percent U.S. shareholder of a CFC receives a basis increase with respect to its stock in the CFC equal to the amount of the CFC's earnings that are included in the 10-percent U.S. shareholder's income under subpart F.[1302] Similarly, a 10-percent U.S. shareholder of a CFC generally reduces its basis in the CFC's stock in an amount equal to any distributions that the 10-percent U.S. shareholder receives from the CFC that are excluded from its income as previously taxed under subpart F.[1303]

Passive Foreign Investment Companies

The Tax Reform Act of 1986 [1304] established the PFIC anti-deferral regime. A PFIC is generally defined as any foreign corporation if 75 percent or more of its gross income for the taxable year

[1298] Subject to approval by the IRS, a taxpayer may establish that the reserve of a life insurance company for life insurance and annuity contracts is the amount taken into account in determining the foreign statement reserve for the contract (reduced by catastrophe, equalization, or deficiency reserve or any similar reserve). IRS approval is to be based on whether the method, the interest rate, the mortality and morbidity assumptions, and any other factors taken into account in determining foreign statement reserves (taken together or separately) provide an appropriate means of measuring income for Federal income tax purposes.
[1299] IRC section 959(a)(1).
[1300] IRC section 959(a)(2).
[1301] IRC section 959(c).
[1302] IRC section 961(a).
[1303] IRC section 961(b).
[1304] Public Law Number 99-514.

consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income.[1305] Alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a PFIC, regardless of their percentage ownership in the company. One set of rules applies to PFICs that are qualified electing funds, under which electing U.S. shareholders currently include in gross income their respective shares of the company's earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.[1306] A second set of rules applies to PFICs that are not qualified electing funds, under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest charge that is attributable to the value of deferral.[1307] A third set of rules applies to PFIC stock that is marketable, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as ‘‘marking to market."[1308]

Under the PFIC regime, passive income is any income which is of a kind that would be foreign personal holding company income, including dividends, interest, royalties, rents, and certain gains on the sale or exchange of property, commodities, or foreign currency. However, among other exceptions, passive income does not include any income derived in the active conduct of an insurance business by a corporation that is predominantly engaged in an insurance business and that would be subject to tax under subchapter L if it were a domestic corporation.[1309] In applying the insurance exception, the IRS analyzes whether risks assumed under contracts issued by a foreign company organized as an insurer are truly insurance risks, whether the risks are limited under the terms of the contracts, and the status of the company as an insurance company.[1310]

Other Anti-Deferral Rules

The subpart F and PFIC rules are not the only anti-deferral regimes. Other rules that impose current U.S. taxation on income earned through corporations include the accumulated earnings tax rules[1311] and the personal holding company rules.

Rules for coordination among the various anti-deferral regimes are provided to prevent U.S. persons from being subject to U.S. tax on the same item of income under those multiple regimes. For example, a corporation generally is not treated as a PFIC with respect to a particular shareholder if the corporation is also a CFC and the shareholder is a 10-percent U.S. shareholder. Thus, in that regard, the subpart F rules take precedence over the PFIC rules.

[1305] IRC section 1297.
[1306] IRC sections 1293-1295.
[1307] IRC section 1291.
[1308] IRC section 1296.
[1309] IRC section 1297(b)(2)(B).
[1310] Notice 2003-34, 2003-C.B. 1 990, June 9, 2003. See also, Proposed Treasury Regulation section 1.12974, 26 CFR Part 1, REG-108214-15, April 24, 2015.
[1311] IRC sections 531-537.

3. Foreign Tax Credit

Subject to certain limitations, U.S. citizens, resident individuals, and domestic corporations are allowed to claim a credit for foreign income taxes they pay. A domestic corporation that owns at least 10 percent of the voting stock of a foreign corporation is allowed a "deemed-paid" credit for foreign income taxes paid by the foreign corporation that the domestic corporation is deemed to have paid when the related income is distributed as a dividend or is included in the domestic corporation's income under the anti-deferral rules.[1312]

The foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income (as determined under U.S. tax accounting principles). This limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income.[1313] The limit is computed by multiplying a taxpayer's total U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year, the taxpayer may carry back the excess foreign taxes to the previous year or carry forward the excess taxes to one of the succeeding 10 years.[1314]

The computation of the foreign tax credit limitation requires a taxpayer to determine the amount of its taxable income from foreign sources in each limitation category (described below) by allocating and apportioning deductions between U.S.-source gross income, on the one hand, and foreign-source gross income in each limitation category, on the other. In general, deductions are allocated and apportioned to the gross income to which the deductions factually relate.[1315] However, subject to certain exceptions, deductions for interest expense and research and experimental expenses are apportioned based on taxpayer ratios.[1316] In the case of interest expense, this ratio is the ratio of the corporation's foreign or domestic (as applicable) assets to its worldwide assets. In the case of research and experimental expenses, the apportionment ratio is based on either sales or gross income. All members of an affiliated group of corporations generally are treated as a single corporation for purposes of determining the apportionment ratios.[1317]

The term "affiliated group" is determined generally by reference to the rules for determining whether corporations are eligible to file consolidated returns.[1318] These rules exclude foreign corporations from an affiliated group.[1319] Interest expense allocation rules permitting a U.S. affiliated group to apportion the interest expense of the members of the U.S. affiliated group on a worldwide-group basis were modified in 2004, and initially effective for taxable years beginning after December 31, 2008.[1320] The effective date of the modified rules has been delayed to

1312 IRC sections 901, 902, 960, 1291(g).
1313 IRC sections 901, 904.
1314 IRC section 904(c).
1315 Treasury Regulation section 1.861-8(b), Temporary Treasury Regulation section 1.861-8T(c).
1316 Temporary Treasury Regulation section 1.861-9T, Treasury Regulation section 1.861-17.
1317 IRC section 864(e)(1), (6); Temporary Treasury Regulation section 1.861-14T(e)(2).
1318 IRC sections 864(e)(5), 1504.
1319 IRC section 1504(b)(3).
1320 IRC section 864(f); "American Jobs Creation Act of 2004" (AJCA"), Pub. L. 108-357, section 401(a).

January 1, 2021.[1321] A result of this rule is that interest expense of foreign members of a U.S. affiliated group is taken into account in determining whether a portion of the interest expense of the domestic members of the group must be allocated to foreign-source income. An allocation to foreign-source income generally is required only if, in broad terms, the domestic members of the group are more highly leveraged than is the entire worldwide group. The new rules are generally expected to reduce the amount of the U.S. group's interest expense that is allocated to foreign-source income.

The foreign tax credit limitation is applied separately to passive category income and to general category income.[1322] Passive category income includes passive income, such as portfolio interest and dividend income, and certain specified types of income. All other income is in the general category. Passive income is treated as general category income if it is earned by a qualifying financial services entity. Passive income is also treated as general category income if it is highly taxed (that is, if the foreign tax rate is determined to exceed the highest rate of tax specified in IRC section 1 or 11, as applicable). Dividends (and subpart F inclusions), interest, rents, and royalties received by a 10-percent U.S. shareholder from a CFC are assigned to a separate limitation category by reference to the category of income out of which the dividends or other payments were made.[1323] Dividends received by a 10-percent corporate shareholder of a foreign corporation that is not a CFC are also categorized on a look-through basis.[1324]

Special rules apply to the allocation of income and losses from foreign and U.S. sources within each category of income.[1325] Foreign losses from one category will first be used to offset income from foreign sources of other categories. If there remains an overall foreign loss, it will be deducted against income from U.S. sources. The same principle applies to losses from U.S. sources. In subsequent years, the losses that were deducted against another category or source of income will be recaptured. That is, an equal amount of income from the same category or source that generated a loss in the prior year will be recharacterized as income from the other category or source against which the loss was deducted. Up to 50 percent of income from one source in any subsequent year will be recharacterized as income from the other source, whereas foreign-source income in a particular category can be fully recharacterized as income in another category until the losses from prior years are fully recaptured.[1326]

[1321] Hiring Incentives to Restore Employment Act, Public Law Number 111-147, section 551(a).
[1322] IRC section 904(d). AJCA generally reduced the number of income categories from nine to two, effective for tax years beginning in 2006. Before AJCA, the foreign tax credit limitation was applied separately to the following categories of income: (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) certain dividends received from noncontrolled IRC section 902 foreign corporations (also known as "10/50 companies"), (6) certain dividends from a domestic international sales corporation or former domestic international sales corporation, (7) taxable income attributable to certain foreign trade income, (8) certain distributions from a foreign sales corporation or former foreign sales corporation, and (9) any other income not described in items (1) through (8) (so-called "general basket" income). A number of other provisions of the IRC, including several enacted in 2010 as part of Public Law Number 111-226, create additional separate categories in specific circumstances or limit the availability of the foreign tax credit in other ways. See, e.g., IRC sections 865(h), 901(j), 904(d)(6), 904(h)(10).
[1323] IRC section 904(d)(3). The subpart F rules applicable to CFCs and their 10-percent U.S. shareholders are described below.
[1324] IRC section 904(d)(4).
[1325] IRC sections 904(f), (g).
[1326] IRC sections 904(f)(1), (g)(1).

In addition to the foreign tax credit limitation described above, a taxpayer's ability to claim a foreign tax credit may be further limited by a matching rule that prevents the separation of creditable foreign taxes from the associated foreign income. Under this rule, a foreign tax generally is not taken into account for U.S. tax purposes, and thus no foreign tax credit is available with respect to that foreign tax, until the taxable year in which the related income is taken into account for U.S. tax purposes.[1327]

4. Special rules

Dual Consolidated Loss Rules

Under the rules applicable to corporations filing consolidated returns, a dual consolidated loss (DCL) is any net operating loss of a domestic corporation if the corporation is subject to an income tax of a foreign country without regard to whether such income is from sources in or outside of such foreign country, or if the corporation is subject to such a tax on a residence basis (a "dual resident corporation").[1328] A DCL generally cannot be used to reduce the taxable income of any member of the corporation's affiliated group. Losses of a separate unit of a domestic corporation (a foreign branch or an interest in a hybrid entity owned by the corporation) are subject to this limitation in the same manner as if the unit were a wholly owned subsidiary of such corporation. An exemption is available under Treasury regulations in the case of DCLs for which a domestic use election (that is, an election to use the loss only for domestic, and not foreign, tax purposes) has been made.[1329] Recapture is required, however, upon the occurrence of certain triggering events, including the conversion of a separate unit to a foreign corporation and the transfer of 50 percent or more of the assets of a separate unit within a twelve-month period.[1330]

Temporary Dividends-Received Deduction for Repatriated Foreign Earnings

In 2004, AJCA section 421 added IRC section 965, a temporary provision intended to encourage U.S. multinational companies to repatriate foreign earnings. Under IRC section 965, for one taxable year certain dividends received by a U.S. corporation from its CFCs were eligible for an 85-percent dividends-received deduction. At the taxpayer's election, this deduction was available for dividends received either during the taxpayer's first taxable year beginning on or after October 22, 2004, or during the taxpayer's last taxable year beginning before such date.[1331]

The temporary deduction was subject to a number of general limitations. First, it applied only to cash repatriations generally in excess of the taxpayer's average repatriation level calculated for a three-year base period preceding the year of the deduction. Second, the amount of dividends eligible for the deduction was generally limited to the amount of earnings shown as permanently invested outside the United States on the taxpayer's recent audited financial statements. Third, to qualify for the deduction, dividends were required to be invested in the United States according to

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[1327] IRC section 909.
[1328] IRC section 1503(d).
[1329] Treasury Regulation section 1.1503(d)-6(d).
[1330] See Treasury Regulation section 1.1503(d)-6(e)(1).
[1331] 2004 Summary of Federal Income Tax Changes.

a domestic reinvestment plan approved by the taxpayer's senior management and board of directors.[1332]

No foreign tax credit (or deduction) was allowed for foreign taxes attributable to the deductible portion of any dividend.[1333] For this purpose, the taxpayer was permitted to specifically identify which dividends were treated as carrying the deduction and which dividends were not. In other words, the taxpayer was allowed to choose which of its dividends were treated as meeting the base-period repatriation level (and thus carry foreign tax credits, to the extent otherwise allowable), and which of its dividends were treated as part of the excess eligible for the deduction (and thus subject to proportional disallowance of any associated foreign tax credits).[1334] Deductions were disallowed for expenses that were directly allocable to the deductible portion of any dividend.[1335]

Domestic International Sales Corporations

A domestic international sales corporations (DISC) is a domestic corporation that satisfies the following conditions: 95 percent of its gross receipts must be qualified export receipts; 95 percent of the sum of the adjusted bases of all its assets must be attributable to the sum of the adjusted bases of qualified export assets; the corporation must have no more than one class of stock; the par or stated value of the outstanding stock must be at least $2,500 on each day of the taxable year; and an election must be in effect to be taxed as a DISC.[1336] In general, a DISC is not subject to corporate-level tax and offers limited deferral of tax liability to its shareholders.[1337] DISC income attributable to a maximum of $10 million annually of qualified export receipts is generally exempt from income tax at both the corporate and shareholder level. Shareholders must pay interest to account for the benefit of deferring the tax liability on undistributed DISC income related to this $10 million maximum annual amount.[1338] Such entities are also referred to as interest charge DISCs, or IC-DISCs. Shareholders of a DISC are deemed to receive a dividend out of current earnings and profits from qualified export receipts in excess of $10 million.[1339] Gain on

[1332] IRC section 965(b)(4). The plan was required to provide for the reinvestment of the repatriated dividends in the United States, including as a source for the funding of worker hiring and training, infrastructure, research and development, capital investments, and the financial stabilization of the corporation for the purposes of job retention or creation.
[1333] IRC section 965(d)(1).
[1334] Accordingly, taxpayers generally were expected to pay regular dividends out of high-taxed CFC earnings (thereby generating deemed-paid credits available to offset foreign-source income) and IRC section 965 dividends out of low-taxed CFC earnings (thereby availing themselves of the 85-percent deduction).
[1335] IRC section 965(d)(2).
[1336] IRC sections 992(a) and (b). If a corporation fails to satisfy either or both of the 95-percent tests, it is deemed to satisfy such tests if it makes a pro rata distribution of its gross receipts which are not qualified export receipts and the fair market value of its assets which are not qualified export assets. IRC section 992(c).
[1337] IRC section 991. Prior to the 1984 Revenue Act (Pub. L. 98-369), DISCs were eligible for more generous tax benefits that were eliminated in favor of the since-repealed foreign sales corporation regime (FSC). An overview of the history of the DISCs and FSCs regimes is provided in Joseph Isenbergh, Vol. 3 *U.S. Taxation of Foreign Persons and Foreign Income,* Para. 81. (Fourth Ed. 2016).
[1338] The rate is the average of one-year constant maturity Treasury yields. The deferral benefit is the excess of the amount of tax for which the shareholder would be liable if deferred DISC income were included as ordinary income over the actual tax liability of such shareholder. IRC section 995(f).
[1339] The amount of the deemed distribution is the sum of several items, including qualified export receipts in excess of $10 million. See IRC section 955(b).

the sale of DISC stock is treated as a dividend to the extent of accumulated DISC income.[1340] The shareholders of a corporation which is not a DISC, but was a DISC in a previous taxable year, and which has previously taxed income or accumulated DISC income, are also required to pay interest on the deferral benefit, and gain on the sale or exchange of stock in such corporation is treated as a dividend.

Part I—Outbound Transactions

Subpart A—Establishment of Participation Exemption System for Taxation of Foreign Income

Section	Section Title
14101	Deduction for Foreign-Source Portion of Dividends Received by Domestic Corporations from Specified 10-Percent Owned Foreign Corporations

New Federal Law (IRC new section 245A)

In General

The provision allows an exemption for certain foreign income by means of a 100-percent deduction for the foreign-source portion of dividends received from specified 10-percent owned foreign corporations by domestic corporations[1341] that are United States shareholders of those foreign corporations within the meaning of IRC section 951(b)[1342] (referred to here, as above, as a dividend received distribution (DRD)).

A specified 10-percent owned foreign corporation is any foreign corporation (other than a PFIC that is not also a CFC) with respect to which any domestic corporation is a U.S. shareholder.[1343]

The term “dividend received” is intended to be interpreted broadly, consistently with the meaning of the phrases “amount received as dividends” and “dividends received” under IRC sections 243 and 245, respectively. For example, if a domestic corporation indirectly owns stock of a foreign corporation through a partnership and the domestic corporation would qualify for the participation DRD with respect to dividends from the foreign corporation if the domestic corporation owned such stock directly, the domestic corporation would be allowed a participation DRD with respect to its distributive share of the partnership's dividend from the foreign corporation.

[1340] IRC section 995(c).
[1341] Including a controlled foreign corporation treated as a domestic corporation for purposes of computing the taxable income thereof. See Treasury Regulation section 1.952-2(b)(1). Therefore, a CFC receiving a dividend from a 10-percent owned foreign corporation that constitutes subpart F income may be eligible for the DRD with respect to such income.
[1342] Under IRC section 951(b), as revised by the Act, a domestic corporation is a United States shareholder of a foreign corporation if it owns, within the meaning of IRC section 958(a), or is considered as owning by applying the rules of IRC section 958(b), 10-percent or more of the vote or value of the foreign corporation.
[1343] IRC sections 1297, 1298.

The DRD is available only to C corporations that are not RICs or REITs.

Foreign-Source Portion of a Dividend

The DRD is available only for the foreign-source portion of dividends received by a domestic corporation from specified 10-percent owned foreign corporations. The foreign-source portion of any dividend is the amount that bears the same ratio to the dividend as the undistributed foreign earnings bears to the total undistributed earnings of the foreign corporation. Undistributed earnings are the amount of the earnings and profits of a specified 10-percent owned foreign corporation[1344] as of the close of the taxable year of the specified 10-percent owned foreign corporation in which the dividend is distributed and not reduced by dividends[1345] distributed during that taxable year. Undistributed foreign earnings are the portion of the undistributed earnings attributable to neither income described in IRC section 245(a)(5)(A) nor IRC section 245(a)(5)(B), without regard to IRC section 245(a)(12).

Hybrid Dividends

The DRD is not available for any dividend received by a U.S. shareholder from a controlled foreign corporation if the dividend is a hybrid dividend. A hybrid dividend is an amount received from a controlled foreign corporation for which a deduction would be allowed under this provision and for which the specified 10-percent owned foreign corporation received a deduction (or other tax benefit) with respect to any income, war profits, and excess profits taxes imposed by any foreign country.

If a controlled foreign corporation with respect to which a domestic corporation is a U.S. shareholder receives a hybrid dividend from any other controlled foreign corporation with respect to which the domestic corporation is also a U.S. shareholder, then the hybrid dividend is treated for purposes of IRC section 951(a)(1)(A) as subpart F income of the recipient controlled foreign corporation (notwithstanding IRC section 954(c)(6)) for the taxable year of the controlled foreign corporation in which the dividend was received and the U.S. shareholder includes in gross income an amount equal to the shareholder's pro rata share of the subpart F income, determined in the same manner as under IRC section 951(a)(2).

Foreign Tax Credit Disallowance

No foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to any portion of a distribution treated as a dividend that qualifies for the DRD.

For purposes of computing the IRC section 904(a) foreign tax credit limitation, a domestic corporation that is a U.S. shareholder of a specified 10-percent owned foreign corporation must compute its foreign-source taxable income (and entire taxable income) by disregarding the

[1344] Computed in accordance with IRC sections 964(a) and 986.
[1345] Pursuant to IRC section 959(d), a distribution of previously taxed income does not constitute a dividend even if it reduces earnings and profits.

foreign-source portion of any dividend received from that foreign corporation for which the DRD is taken, and any deductions properly allocable or apportioned to that foreign-source portion or the stock with respect to which it is paid.

Holding Period Requirement

A domestic corporation is not permitted a DRD in respect of any dividend on any share of stock that is held by the domestic corporation for 365 days or less during the 731-day period beginning on the date that is 365 days before the date on which the share becomes ex-dividend with respect to the dividend. For this purpose, the holding period requirement is treated as met only if the specified 10-percent owned foreign corporation is a specified 10-percent owned foreign corporation at all times during the period and the taxpayer is a U.S. shareholder with respect to such specified 10-percent owned foreign corporation at all times during the period.

Effective Dates

The provision applies to distributions made (and for purposes of determining a taxpayer's foreign tax credit limitation under IRC section 904, deductions with respect to taxable years ending after) after December 31, 2017.

California Law (Revenue and Taxation Code (R&TC) Sections 17024.5, 23051.5, 24411, 25101, 25106, 25110, and 25116)

California does not conform to the new federal IRC section 245A.

Worldwide Unitary Method

California corporate taxpayers doing business both within and without California are required to compute their California franchise or income tax using the worldwide unitary method. Under this method, a corporate taxpayer's business income from both domestic and foreign unitary operations is considered in the calculation of the taxpayer's tax base, and a share of that business income is then “apportioned” to California using a formula. Income apportioned to California is subject to California franchise or income tax. The formula measures relative levels of business activity in the state by using the amount of the taxpayer’s sales in California divided by the taxpayer's sales everywhere.[1346] This measure of activities is commonly called the “single sales-factor formula.” The amount of sales from both domestic and foreign activities are included in the calculation of the apportionment formula. Generally, dividends paid from one member to another within the unitary group from unitary earnings are eliminated from tax computations under R&TC section 25106.

[1346] An apportioning trade or business conducting certain qualified business activities is required to use an evenly weighted three-factor formula consisting of property, payroll, and sales to apportion its business income to California. (R&TC section 25128.)

California Water's-Edge Election

As an alternative to the worldwide unitary method, California law allows corporations to elect to determine the business income of their combined reporting group on a "water's-edge" basis. In general, the water's-edge method excludes foreign corporations from the calculation of business income. An exception to this general rule is a CFC with subpart F income. The income and factors of the CFC are included in a water's-edge combined report based on the CFC's inclusion ratio. This ratio is equal to the CFC's current year subpart F income divided by the CFC's current year earnings and profits. While California does not conform to the subpart F scheme of the IRC, for purposes of computing the CFC's inclusion ratio under water's-edge, California incorporates the federal definitions of "subpart F income" and "earnings and profits" as applicable for federal income tax purposes for the same taxable year.[1347]

Generally, rather than computing a dividends-received deduction using federal DRD provisions, dividends paid to the water's-edge combined reporting group from foreign affiliates are income on the water's-edge combined report and California taxpayers electing water's-edge treatment are generally entitled to a 75 percent dividends-received deduction on such dividends under R&TC section 24411.

Taxpayers can and do change their decision to elect water's-edge treatment. A taxpayer who elects water's-edge treatment must elect that treatment for seven years before they can terminate their election at their own discretion. A taxpayer who had terminated a water's-edge election and is thereafter using worldwide combined reporting treatment must wait seven years before they can re-elect for water's-edge treatment.

California does not allow a foreign tax credit.

<u>Impact on California Revenue</u>

Not applicable.

[1347] R&TC section 25116. This is limited to provisions of the IRC referred to in the water's edge election provisions that are not otherwise applicable for California franchise or income tax purposes.

Section	Section Title
14102	Special Rules Relating to Sales or Transfers Involving Specified 10-Percent Owned Foreign Corporations

New Federal Law (IRC sections 367(a)(3)(C), 961, 964, 1248 and new section 91)

Sales by United States Persons of Stock/Coordination with Dividend Received Deduction

In the case of the sale or exchange by a domestic corporation of stock in a foreign corporation held for one year or more, any amount received by the domestic corporation which is treated as a dividend for purposes of IRC section 1248, is treated as a dividend for purposes of applying the deduction under IRC section 245A to the extent of the foreign-source portion of such dividend.

Reduction in Basis of Certain Foreign Stock

Solely for the purpose of determining a loss, a domestic corporate shareholder's adjusted basis in the stock of a specified 10-percent owned foreign corporation (as defined in this provision) is reduced by an amount equal to the portion of any dividend received with respect to such stock from such foreign corporation that was not taxed by reason of a dividends received deduction allowable under IRC section 245A in any taxable year of such domestic corporation. This rule applies in coordination with IRC section 1059, such that any reduction in basis required pursuant to this provision will be disregarded, to the extent the basis in the specified 10-percent owned foreign corporation's stock has already been reduced (but not below zero) pursuant to IRC section 1059.

Sale by a CFC of a Lower-Tier CFC

If for any taxable year of a CFC beginning after December 31, 2017, an amount is treated as a dividend under IRC section 964(e)(1) because of a sale or exchange by the CFC of stock in another foreign corporation held for a year or more, then: (i) the foreign-source portion of the dividend is treated as subpart F income of the selling CFC for purposes of IRC section 951(a)(1)(A) for that taxable year, (ii) a United States shareholder with respect to the selling CFC includes in gross income for the taxable year of the shareholder with or within the taxable year of the CFC ends, an amount equal to the shareholder's pro rata share (determined in the same manner as under IRC section 951(a)(2)) of the amount treated as subpart F income under (i), and (iii) the deduction under IRC section 245A(a) is allowable to the United States shareholder with respect to the subpart F income included in gross income under (ii) in the same manner as if the subpart F income were a dividend received by the shareholder from the selling CFC.

In the case of a sale or exchange by a CFC of stock in another corporation in a taxable year of the selling CFC beginning after December 31, 2017, rules similar to IRC section 961(d) apply.

Inclusion of Transferred Loss Amount in Certain Assets Transfers

Under the provision, if a domestic corporation transfers substantially all of the assets of a foreign branch (within the meaning of IRC section 367(a)(3)(C)) as in effect before the date of enactment of Tax Cuts and Jobs Act (TCJA) to a specified 10-percent owned foreign corporation with respect to which it is a U.S. shareholder after the transfer, the domestic corporation includes in gross income an amount equal to the transferred loss amount, subject to certain limitations.

The transferred loss amount is the excess (if any) of: (1) losses incurred by the foreign branch after December 31, 2017, and before the transfer, for which a deduction was allowed to the domestic corporation, over (2) the sum of certain taxable income earned by the foreign branch and gain recognized by reason of an overall foreign loss recapture arising out of disposition of assets on account of the underlying transfer. For the purposes of (2), only taxable income of the foreign branch in taxable years after the loss is incurred through the close of the taxable year of the transfer, is included. The transferred loss amount is reduced by the amount of gain recognized by the taxpayer (other than gain recognized by reason of an overall foreign loss recapture) on account of the transfer.

Amounts included in gross income by reason of the provision are treated as derived from sources within the United States. Consistent with regulations or guidance that the Secretary of the Treasury may prescribe, proper adjustments are made in the adjusted basis of the taxpayer's stock in the specified 10-percent owned foreign corporation to which the transfer is made, and in the transferee's adjusted basis in the property transferred, to reflect amounts included in gross income under this provision.

The amount of gain taken into account under this provision is reduced by the amount of gain which would be recognized under IRC section 367(a)(3)(C) as in effect before the date of enactment of TCJA[1348] with respect to losses (without regard to the new amendment regarding basis adjustments in IRC section 91(e)) incurred before January 1, 2018.

Repeal of Active Trade or Business Exception

IRC section 367 is amended to provide that in connection with any exchange described in IRC sections 332, 351, 354, 356, or 361, if a U.S. person transfers property used in the active conduct of a trade or business to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation.

[1348] Determined without regard to the rule providing for proper adjustment of basis in the stock in the specified 10-percent owned foreign corporation to which the transfer is made.

Effective Dates

The provisions relating to sales or exchanges of stock apply to sales or exchanges after December 31, 2017.

The provision relating to reduction of basis in certain foreign stock for the purposes of determining a loss is effective for distributions made after December 31, 2017.

The provisions relating to transfer of loss amounts from foreign branches to certain foreign corporations and to the repeal of the active trade or business exception are effective for transfers after December 31, 2017.

California Law (R&TC sections 17024.5, 17081, 17321, 24451, 24990.7, and 25110)

California conforms by reference to IRC section 367, relating to foreign corporations, in R&TC sections 17321, 17024.5(b)(9), and 24451, as of the "specified date" of January 1, 2015.

California does not conform to IRC section 1248, relating to gains from certain sales or exchanges of stock in certain foreign corporations.

California conforms, with modifications, exceptions, and revisions, to various provisions of Part II of Subchapter B of Chapter I of Subtitle A (sections 71 to 91) of the IRC, relating to items specifically included in gross income, as of the "specified date" of January 1, 2015.

California does not conform to subpart F (sections 951 to 965) of the IRC, relating to controlled foreign corporations, except to the extent applicable with respect to water's edge elections.

Worldwide Unitary Method

California corporate taxpayers doing business both within and without California are required to compute their California franchise or income tax using the worldwide unitary method. Under this method, a corporate taxpayer's business income from both domestic and foreign unitary operations is considered in the calculation of the taxpayer's tax base, and a share of that business income is then "apportioned" to California using a formula. Income apportioned to California is subject to California franchise or income tax. The formula measures relative levels of business activity in the state by using the amount of the taxpayer's sales in California divided by the taxpayer's sales everywhere.[1349] This measure of activities is commonly called the "single sales-factor formula." The amount of sales from both domestic and foreign activities are included in the calculation of the apportionment formula. Generally, dividends paid from one member to another within the unitary group from unitary earnings are eliminated from tax computations under R&TC section 25106.

[1349] An apportioning trade or business conducting certain qualified business activities is required to use an evenly weighted three-factor formula consisting of property, payroll, and sales to apportion its business income to California. (R&TC section 25128.)

California Water's-Edge Election

As an alternative to the worldwide unitary method, California law allows corporations to elect to determine the business income of their combined reporting group on a "water's-edge" basis. In general, the water's-edge method excludes foreign corporations from the calculation of business income. An exception to this general rule is a controlled foreign corporation (CFC) with subpart F income. The income and factors of the CFC are included in a water's-edge combined report based on the CFC's inclusion ratio. The ratio is equal to the CFC's current year subpart F income divided by the CFC's current year earnings and profits. While California does not conform to the subpart F scheme of the IRC, for purposes of computing the CFC's inclusion ratio, California incorporates the federal definitions of "subpart F income" and "earnings and profits" as applicable for federal income tax purposes for the taxable year.[1350]

Generally, rather than computing a dividends-received deduction using federal DRD provisions, dividends paid to the water's-edge combined reporting group from foreign affiliates are income on the water's-edge combined report and California taxpayers electing water's-edge treatment are generally entitled to a 75 percent dividends-received deduction on such dividends under R&TC section 24411.

Taxpayers can and do change their decision to elect water's-edge treatment. A taxpayer who elects water's-edge treatment must elect that treatment for seven years before they can terminate their election at their own discretion. A taxpayer who had terminated a water's-edge election and is thereafter using worldwide combined reporting treatment must wait seven years before they can re-elect for water's-edge treatment.

California does not allow a foreign tax credit.

<u>Impact on California Revenue</u>

Estimated Conformity Revenue Impact of Special Rules Relating to Sales or Transfers Involving Specified 10-Percent Owned Foreign Corporations For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	Indeterminate[1351]	Indeterminate[1352]	Indeterminate[1353]

[1350] R&TC section 25116. This is limited to provisions of the IRC referred to in the water's edge election provisions that are not otherwise applicable for California franchise or income tax purposes.
[1351] There would be an indeterminate revenue impact from this provision that could be a revenue gain or loss depending upon the taxpayer's circumstances.
[1352] Ibid.
[1353] Ibid.

Section	Section Title
14103	Treatment of Deferred Foreign Income upon Transition to Participation Exemption System of Taxation

New Federal Law (IRC section 965)

In General

The provision generally requires that, for the last taxable year beginning before January 1, 2018, any taxpayer that is U.S. shareholder of a specified foreign corporation must include in income its pro rata share of the accumulated post-1986 deferred foreign income of the corporation. For purposes of this provision, a specified foreign corporation is any foreign corporation that has at least one U.S. shareholder. It excludes PFICs that are not also CFCs. A portion of that pro rata share of foreign earnings is deductible; the amount of the deductible portion depends upon whether the deferred earnings are held in cash or other assets. The deduction results in a reduced rate of tax with respect to income from the required inclusion of pre-effective date earnings. A corresponding portion of the credit for foreign taxes is disallowed, thus limiting the credit to the taxable portion of the included income. The separate foreign tax credit limitation rules of prior law IRC section 904 apply, with coordinating rules. The increased tax liability generally may be paid over an eight-year period. Special rules are provided for S corporations and real estate investment trusts (REITs).

Subpart F

The mechanism for requiring an inclusion of pre-effective-date foreign earnings is subpart F. The provision provides that in the last taxable year of a deferred foreign income corporation that begins before January 1, 2018, which is that foreign corporation's last taxable year before the transition to the new corporate tax regime elsewhere in the TCJA goes into effect, the subpart F income of the foreign corporation is increased by the greater of the accumulated post-1986 deferred foreign income of the corporation, determined as of November 9, 2017, or as of December 31, 2017 (measurement date). The amount so determined is includible in gross income under IRC section 951 (hereinafter, ‘‘the section 951 inclusion").

The transition rule applies to all U.S. shareholders[1354] of a deferred foreign income corporation. “Deferred foreign income corporation” is any specified foreign corporation with accumulated post-1986 deferred income that is greater than zero. A specified foreign corporation is defined as any CFC as well as any IRC section 902 corporation, as defined in IRC section 909(d)(5) prior to date of enactment of the TCJA, *i.e.*, any foreign corporation in which a U.S. person owns 10 percent of the voting stock. Consistent with the general operation of subpart F, each U.S. shareholder of a

[1354] IRC section 951(b) defines United States shareholder as any U.S. person that owns 10 percent or more of combined voting classes of stock of a foreign corporation.

deferred foreign income corporation must include in income the shareholder's pro rata share of the foreign corporation's subpart F income attributable to its IRC section 951 inclusion.[1355]

Accumulated Post-1986 Deferred Foreign Income

A specified foreign corporation's accumulated post-1986 deferred foreign income on the measurement date is based on all post-1986 foreign earnings and profits (E&P) that are not previously taxed and are neither (1) attributable to income that is effectively connected with the conduct of a trade or business in the United States and subject to U.S. income tax nor (2) subpart F income (determined without regard to the IRC section 951 inclusion) included in the gross income of a U.S. shareholder. The potential pool of includible earnings includes all undistributed foreign earnings accumulated in taxable years beginning after 1986, computed in accordance with IRC sections 964(a) and 986, taking into account only periods when the foreign corporation was a specified corporation. The pool of post-1986 foreign earnings and profits is not reduced by distributions during the taxable year to which IRC section 965 applies.

Reductions of Amounts Included In Income of U.S. Shareholder of Foreign Corporations with Deficits in E&P

The pool of post-1986 earnings and profits taken into consideration in computing the IRC section 951 inclusion required of a U.S. shareholder under this transition rule generally is reduced by foreign earnings and profits deficits that are properly allocated to that person. The U.S. shareholder must determine its aggregate E&P deficit based on its interest in each specified foreign corporation with a deficit in post-1986 foreign earnings and profits as of the measurement date (E&P deficit foreign corporation).

The U.S. shareholder's aggregate E&P deficit is then allocated among the deferred foreign income corporations in the same ratio as the U.S. shareholder's pro rata share of post-1986 deferred income in that corporation bears to the U.S. shareholder's pro rata share of accumulated post-1986 deferred foreign income from all deferred foreign income corporations with respect to which the shareholder is a U.S. shareholder. For the portion of aggregate E&P deficits that include qualified deficits, the portion of the deficit that is attributable to a qualified deficit, and the qualified activity, must be identified. The provision does not permit intragroup netting among U.S. shareholders within an affiliated group.

In taxable years beginning after 2017, amounts by which the IRC section 951 inclusion was reduced by aggregate E&P deficits are considered as amounts included in the gross income of the U.S. shareholder. The shareholder's pro rata share of the E&P of an E&P deficit foreign corporation that used qualified deficits to reduce its IRC section 951 inclusion is increased by the amount of such deficit and attributed to the same activity to which the income was attributed.

[1355] For purposes of taking into account its subpart F income under this rule, a noncontrolled IRC section 902 corporation is treated as a CFC.

Scope of Earnings and Profits Subject to the Transition Tax

The provision applies to all CFCs. It also applies to all foreign corporations (other than PFICs), in which a U.S. person owns a 10-percent voting interest, rather than only CFCs and those corporations within the definition of an IRC section 902 corporation. However, in the case of a foreign corporation that is not a CFC, there must be at least one U.S. shareholder that is a domestic corporation in order for the foreign corporation to be a specified foreign corporation. Such entities must determine their deferred foreign income based on the greater of the aggregate post-1986 accumulated foreign earnings and profits as of November 2, 2017 or December 31, 2017, not reduced by distributions during the taxable year ending with or including the measurement date, unless such distributions were made to another specified foreign corporation. The portion of post-1986 earnings and profits subject to the transition tax does not include earnings and profits that were accumulated by a foreign company prior to attaining its status as a specified foreign corporation.

Deferred earnings of a U.S. shareholder are reduced (but not below zero) by the shareholder's share of deficits as of November 2, 2017, from a specified foreign corporation that is not a deferred foreign income corporation, including the pro rata share of deficits of another U.S. shareholder in a different U.S. ownership chain within the same U.S. affiliated group. The deficits (including hovering deficits[1356]) of a foreign subsidiary that accumulated while it was a specified foreign corporation may be taken into account in determining the aggregate foreign earnings and profits deficit of a U.S. shareholder. Therefore, the amount of post-1986 earnings and profits of a specified foreign corporation is the amount of positive earnings and profits accumulated as of the measurement date reduced by any deficit in earnings and profits of the specified foreign corporation as of the measurement date, without regard to the limitation category of the earnings or deficit. In taxable years beginning with the year of the IRC section 951 inclusion, amounts by which the IRC section 951 inclusion was reduced by aggregate E&P deficits are considered as amounts included in the gross income of the U.S. shareholder for purposes of applying IRC section 959.

For example, assume that a foreign corporation organized after December 31, 1986, has $100 of accumulated earnings and profits as of November 2, 2017, and December 31, 2017, (determined without diminution by reason of dividends distributed during the taxable year and after any increase for qualified deficits), which consist of $120 general limitation earnings and profits and a $20 passive limitation deficit, the foreign corporation's post-1986 earnings and profits would be $100, even if the $20 passive limitation deficit was a hovering deficit. Foreign income taxes related to the hovering deficit, however, would not generally be deemed paid by the U.S. shareholder recognizing an incremental income inclusion. However, the conferees expect the Secretary may issue guidance to provide that, solely for purposes of calculating the amount of foreign income taxes deemed paid by the U.S. shareholder with respect to an inclusion under IRC section 965, a hovering deficit may be absorbed by current year earnings and profits and the foreign income taxes related to the hovering deficit may be added to the specified foreign

[1356] See Treasury Regulation section 1.367(b)-7(d)(2) (definition of “hovering deficit”).

corporation's post-1986 foreign income taxes in that separate category on a pro rata basis in the year of inclusion.[1357]

In order to avoid double-counting and double non-counting of earnings, the Secretary may provide guidance to adjust the amount of post-1986 earnings and profits of a specified foreign corporation to ensure that a single item of a specified foreign corporation is taken into account only once in determining the income of a United States shareholder subject to this provision. Such an adjustment may be necessary, for example, when there is a deductible payment (e.g., interest or royalties) from one specified foreign corporation to another specified foreign corporation between measurement dates.

The law authorized the Secretary to prescribe regulations necessary or appropriate to provide guidance regarding adjustments to basis and prevent avoidance of the purposes of IRC section 965, including a reduction in earnings and profits, changes in entity classification, or accounting methods.

Application of Participation Exemption Deduction and Related Foreign Tax Credits

Instead of prescribing a fixed percentage of the IRC section 951 inclusion resulting from IRC section 965 for which a partial dividends-received deduction is permitted, the provision adopts the rate equivalent percentage method. As a result, the total deduction from the amount of the IRC section 951 inclusion is the amount necessary to result in a 15.5-percent rate of tax on accumulated post-1986 foreign earnings held in the form of cash or cash equivalents, and 8-percent rate of tax on all other earnings. The calculation is based on the highest rate of tax applicable to corporations in the taxable year of inclusion, even if the U.S. shareholder is an individual.

The use of rate equivalent percentages is intended to ensure that the rates of tax imposed on the deferred foreign income is similar for all U.S. shareholders, regardless of the year in which IRC section 965 gives rise to an income inclusion. Individual U.S. shareholders, and the investors in U.S. shareholders that are pass-through entities, generally can elect application of corporate rates for the year of inclusion.[1358] In addition, the increase in income that is not taxed by reason of the partial dividends-received deduction allowed under this provision is treated as income exempt from tax for purposes of determining the basis in an interest in a partnership or subchapter S corporation, but not as income exempt from tax for purposes of determining the accumulated adjustments account of a subchapter S corporation.[1359] Similarly, the conferees expect the Secretary to provide regulations or other guidance that provide for similar treatment under IRC section 986(c), such that any gain or loss recognized thereunder with respect to distributions of earnings previously taxed (or treated as previously taxed) by reason of IRC section 965(a) will be diminished proportionately to the diminution of the net taxable income resulting from IRC section 965(a) by reason of the deduction allowed under IRC section 965(c).

[1357] *Cf.* Treasury Regulation section 1.367(b)-7(d)(2)(ii) and (iii).
[1358] IRC section 962 allows individuals to make the election for a specific taxable year, subject to regulations provided by the Secretary.
[1359] IRC sections 705(a)(1)(B), 1367(a)(1)(A) and 1368(e)(1)(A).

To reflect the change in the applicable rates of deduction, the amounts by which foreign tax credits are reduced are also changed. In addition, rules exist for coordination of this provision with the limitations on foreign tax credits. Under the coordination rule, the foreign taxes treated as paid or accrued by a domestic corporation as a result of the inclusion are limited to the those taxes in proportion to the taxable portion of the IRC section 965 inclusion. The gross-up amount equals the total foreign income taxes multiplied by a fraction, the numerator of which is the taxable portion of the increased subpart F income under this provision and the denominator of which is the total increase in subpart F income under this provision.

With respect to the denial of the partial dividend to any U.S. shareholder that becomes an expatriated entity within the meaning of IRC section 7874(a)(2) at any point within the ten-year period following enactment of the Tax Cuts and Jobs Act, the provision clarifies that U.S. shareholders acquired by a surrogate corporation are within the scope of the provision only if the surrogate corporation inverted post-enactment.

Determination of Cash Position

The determination of assets to be considered in measuring the cash position of an entity is modified in several ways. First, cash holdings of a specified foreign corporation in the form of publicly traded stock may be excluded to the extent that a U.S. shareholder can demonstrate that the value of such stock was taken into account as cash or cash equivalent by another specified foreign corporation with respect to which such shareholder is a U.S. shareholder.

The provision also provides that the cash position of a U.S. shareholder does not generally include the cash attributable to a direct ownership interest in a partnership, but preserves the rule that cash positions of certain noncorporate foreign entities owned by a specified foreign corporation are taken into account if such entities would be specified foreign corporations with respect to the U.S. shareholder if the entity were a foreign corporation. For example, if a U.S. shareholder owns a five-percent interest in a partnership, the balance of which is held by a specified foreign corporation with respect to which such shareholder is a U.S. shareholder, the partnership is treated as a specified foreign corporation with respect to the U.S. shareholder, and the cash or cash equivalents held by the partnership are includible in the aggregate cash position of the U.S. shareholder on a look-through basis. The conferees anticipate that the Secretary will provide guidance for taking into account only the specified foreign corporation's share of the partnership's cash position, and not the five-percent interest directly owned by the U.S. shareholder.

Limitations on Assessment Extended

The provision also allows an exception to the otherwise applicable limitations period for assessment of tax to ensure that the period for assessment of underpayments in tax related to the treatment of the pre-effective date foreign earnings does not expire prior to six years from the date on which the return initially reflecting the IRC section 951 inclusion was filed.

Installment Payments

A U.S. shareholder may elect to pay the net tax liability resulting from the mandatory inclusion of pre-effective-date undistributed CFC earnings in eight installments.

If installment payments are elected, the provision requires that the payments for each of the first five years equal 8 percent of the net tax liability, the sixth installment equals 15 percent of the net tax liability, increasing to 20 percent for the seventh installment and the remaining balance of 25 percent in the eighth year.

The net tax liability that may be paid in installments is the excess of the U.S. shareholder's net income tax for the taxable year in which the pre-effective-date undistributed CFC earnings are included in income over the taxpayer's net income tax for that year determined without regard to the inclusion. Net income tax means net income tax as defined for purposes of the general business credit, but reduced by the amount of that credit.

An election to pay tax in installments must be made by the due date for the tax return for the taxable year in which the pre-effective-date undistributed CFC earnings are included in income. The Treasury Secretary has authority to prescribe the manner of making the election. The first installment must be paid on the due date (determined without regard to extensions) for the tax return for the taxable year of the income inclusion. Succeeding installments must be paid annually no later than the due dates (without extensions) for the income tax return of each succeeding year. If a deficiency is later determined with respect to the net tax liability, the additional tax due may be prorated among all installment payments in most circumstances. The portions of the deficiency prorated to an installment that was due before the deficiency was assessed must be paid upon notice and demand. The portion prorated to any remaining installment is payable with the timely payment of that installment payment, unless the deficiency is attributable to negligence, intentional disregard of rules or regulations, or fraud with intent to evade tax, in which case the entire deficiency is payable upon notice and demand.

The timely payment of an installment does not incur interest. If a deficiency is determined that is attributable to an understatement of the net tax liability due under this provision, the deficiency is payable with underpayment interest for the period beginning on the date on which the net tax liability would have been due, without regard to an election to pay in installments, and ending with the payment of the deficiency. Furthermore, any amount of deficiency prorated to a remaining installment also bears interest on the deficiency, but not on the original installment amount.

The provision also includes an acceleration rule. If (1) there is a failure to pay timely any required installment, (2) there is a liquidation or sale of substantially all of the U.S. shareholder's assets (including in a bankruptcy case), (3) the U.S. shareholder ceases business, or (4) another similar circumstance arises, the unpaid portion of all remaining installments is due on the date of the event (or, in a title 11 case or similar proceeding, the day before the petition is filed).

Special Rule for S Corporations

A special rule permits deferral of the transition net tax liability for shareholders of a U.S. shareholder that is a flow-through entity known as an S corporation.[1360] The S corporation is required to report on its income tax return the amount includible in gross income by reason of this provision, as well as the amount of deduction that would be allowable, and provide a copy of such information to its shareholders. Any shareholder of the S corporation may elect to defer his portion of the net tax liability at transition to the participation exemption system until the shareholder's taxable year in which a triggering event occurs. The election to defer the tax is due not later than the due date for the return of the S corporation for its last taxable year that begins before January 1, 2018.

Three types of events may trigger an end to deferral of the net tax liability. The first type of triggering event is a change in the status of the corporation as an S corporation. The second category includes liquidation, sale of substantially all corporate assets, termination of the company or end of business, or similar event, including reorganization in bankruptcy. The third type of triggering event is a transfer of shares of stock in the S corporation by the electing taxpayer, whether by sale, death or otherwise, unless the transferee of the stock agrees with the Secretary to be liable for net tax liability in the same manner as the transferor. Partial transfers trigger the end of deferral only with respect to the portion of tax properly allocable to the portion of stock sold.

If a shareholder of an S corporation has elected deferral under the special rule for S corporation shareholders and a triggering event occurs, the S corporation and the electing shareholder are jointly and severally liable for any net tax liability and related interest or penalties. The period within which the IRS may collect such liability does not begin before the date of an event that triggers the end of the deferral. If an election to defer payment of the net tax liability is in effect for a shareholder, that shareholder must report the amount of the deferred net tax liability on each income tax return due during the period that the election is in effect. Failure to include that information with each income tax return will result in a penalty equal to five-percent of the amount that should have been reported.

After a triggering event occurs, a shareholder in the S corporation may elect to pay the net tax liability in eight installments, subject to rules similar to those generally applicable absent deferral. Whether a shareholder may elect to pay in installments depends upon the type of event that triggered the end of deferral. If the triggering event is a liquidation, sale of substantially all corporate assets, termination of the company or end of business, or similar event, the installment payment election is not available. Instead, the entire net tax liability is due upon notice and demand. The installment election is due with the timely return for the year in which the triggering event occurs. The first installment payment is required by the due date of the same return, determined without regard to extensions of time to file.

[1360] IRC section 1361 defines an S corporation as a domestic small business corporation that has an election in effect for status as an S corporation, with fewer than 100 shareholders, none of whom are nonresident aliens, and all of whom are individuals, estates, trusts or certain exempt organizations.

Special Rules for REITs

To alleviate burden of compliance with this section by REITs, special rules are provided if a U.S. shareholder is a REIT. First, although it must determine its pro rata share of the increase in subpart F income in accordance with the rules described above, the REIT is not required to take into account the IRC section 951 inclusion for purposes of determining the REIT's amount of qualified REIT gross income.[1361] The IRC section 951 inclusion is, however, taken into account for purposes of determining the income potentially required to be included in taxable income under IRC section 857(b). Unlike a regular subchapter C corporation, a REIT is able to deduct the portion of its income that is distributed to its shareholders as a dividend or qualifying liquidating distribution each year.[1362] The distributed income of the REIT is not taxed at the entity level; instead, it is taxed once, at the investor level. As a result, a required inclusion under this section may trigger a requirement that the REIT distribute an amount equal to 90 percent of that inclusion despite the fact that it received no distribution from the deferred foreign income corporation.

To avoid requiring that any distribution requirement be satisfied in one year, an election to defer the IRC section 951 inclusion is permitted. Under a timely election, a REIT may instead take the amounts into income over a period of eight years. It must include 8 percent in each of the five years beginning with the initial year in which the IRC section 951 inclusion is determined, 15 percent in the sixth year, 20 percent in the seventh year and 25 percent in the eighth year. In each of those years, it may claim a partial dividends-received deduction in the applicable percentages in proportion to the amount included in each of the eight years. Neither the REIT nor the recipient of the distribution may elect to use the installment payment.

In the event that a REIT liquidates, ceases to operate its business, or distributes substantially all its assets (or any other similar event occurs), any portion of the required inclusion not yet taken into income is accelerated and required to be included as gross income as of the day before the event.

Recapture from Expatriated Entities

The provision denies any deduction claimed with respect to the mandatory subpart F inclusion and imposes a 35-percent tax on the entire inclusion if a U.S. shareholder becomes an expatriated entity within the meaning of IRC section 7874(a)(2) at any point within the ten-year period following enactment of the Tax Cuts and Jobs Act. An entity that becomes a surrogate foreign corporation that is treated as a domestic corporation under IRC section 7874(b) is not within the scope of this recapture provision. Although the amount due is computed by reference

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[1361] To qualify as a REIT, an entity must meet certain income requirements. A REIT is restricted to earning certain types of generally passive income. Among other requirements, at least 75 percent of the gross income of a REIT in each taxable year must consist of real estate-related income. IRC section 856. In addition, a REIT is required to distribute at least 90 percent of REIT income (other than net capital gain) annually. IRC section 857. Even if a REIT meets the 90-percent income distribution requirement for REIT qualification, more stringent distribution requirements must be met in order to avoid an excise tax under IRC section 4981.

[1362] Liquidating distributions are covered to the extent of earnings and profits, and are defined to include redemptions of stock that are treated by shareholders as a sale of stock under IRC section 302. IRC sections 857(b)(2)(B), 561, and 562(b).

to the year in which the deemed subpart F income was originally reported, the additional tax arises and is assessed for the taxable year in which the U.S. shareholder becomes an expatriated entity. No foreign tax credits are permitted with respect to the additional tax due as a result of the recapture rule.

Regulatory Authority

A specific grant of regulatory authority to carry out the intent of this provision is included.

The conferees recognize that basis adjustments (increases or decreases) may be necessary with respect to both the stock of the deferred foreign income corporation and the E&P deficit foreign corporation and authorizes the Secretary to provide for such basis adjustments or other adjustments, as may be appropriate. For example, with respect to the stock of the deferred foreign income corporation, the Secretary may determine that a basis increase is appropriate in the taxable year of the IRC section 951A inclusion or, alternatively, the Secretary may modify the application of IRC section 961(b)(1) with respect to such stock. Moreover, with respect to the stock of the E&P deficit corporation, the Secretary may require a reduction in basis for the taxable year in which the U.S. shareholder's pro rata share of the earnings of the E&P deficit corporation are increased.

In addition, the Secretary may identify instances in which it is appropriate to grant relief from potential double-counting of earnings and profits, which may occur due to different measurement dates applicable to specified foreign corporations within an affiliated group, or the timing of intragroup distributions. It also specifies that the Secretary shall prescribe rules or guidance in order to deter tax avoidance through use of entity classification elections and accounting method changes, among other possible strategies.

<u>Effective Dates</u>

The provision is effective for the last taxable year of a foreign corporation that begins before January 1, 2018, and with respect to U.S. shareholders, for the taxable years in which or with which such taxable years of the foreign corporations end.

<u>California Law (R&TC sections 17024.5, 23051.5. and 25110)</u>

California does not conform to subpart F (sections 951 to 965) of the IRC, relating to controlled foreign corporations, except to the extent applicable with respect to water's-edge elections.

Worldwide Unitary Method

California corporate taxpayers doing business both within and without California are required to compute their California franchise or income tax using the worldwide unitary method. Under this method, a corporate taxpayer's business income from both domestic and foreign unitary operations is considered in the calculation of the taxpayer's tax base, and a share of that business income is then "apportioned" to California using a formula. Income apportioned to California is subject to California franchise or income tax. The formula measures relative levels of business activity in the state by using the amount of the taxpayer's sales in California divided by the taxpayer's sales everywhere.[1363] This measure of activities is commonly called the "single sales-factor formula." The amount of sales from both domestic and foreign activities are included in the calculation of the apportionment formula. Generally, dividends paid from one member to another within the unitary group from unitary earnings are eliminated from tax computations under R&TC section 25106.

California Water's-Edge Election

As an alternative to the worldwide unitary method, California law allows corporations to elect to determine the business income of their combined reporting group on a "water's-edge" basis. In general, the water's-edge method excludes foreign corporations from the calculation of business income. An exception to this general rule is a controlled foreign corporation (CFC) with subpart F income. The income and factors of the CFC are included in a water's-edge combined report based on the CFC's inclusion ratio. The ratio is equal to the CFC's current year subpart F income divided by the CFC's current year earnings and profits. While California does not conform to the subpart F scheme of the IRC, for purposes of computing the CFC's inclusion ratio, California incorporates the federal definitions of "subpart F income" and "earnings and profits" as applicable for federal income tax purposes for the taxable year.[1364]

Generally dividends paid to the water's-edge combined reporting group from foreign affiliates are income on the water's-edge combined report. California taxpayers electing water's-edge treatment are generally entitled to a 75 percent dividends-received deduction on such dividends under R&TC section 24411.

Taxpayers can and do change their decision to elect water's-edge treatment. A taxpayer who elects water's-edge treatment must elect that treatment for seven years before they can terminate their election at their own discretion. A taxpayer who had terminated a water's-edge election and is thereafter using worldwide combined reporting treatment must wait seven years before they can re-elect for water's-edge treatment.

California does not allow a foreign tax credit.

<u>Impact on California Revenue</u>

Baseline.

[1363] An apportioning trade or business conducting certain qualified business activities is required to use an evenly weighted three-factor formula consisting of property, payroll, and sales to apportion its business income to California. (R&TC section 25128.)

[1364] R&TC section 25116. This is limited to provisions of the IRC referred to in the water's edge election provisions that are not otherwise applicable for California franchise or income tax purposes.

Subpart B—Rules Related to Passive and Mobile Income

Chapter 1—Taxation of Foreign-Derived Intangible Income and Global Intangible Low-Taxed Income

Section	Section Title
14201	Current Year Inclusion of Global Intangible Low-Taxed Income by United States Shareholders

New Federal Law (IRC sections 904, 960 and new section 951A)

In General

Under the provision, a U.S. shareholder of any CFC must include in gross income for a taxable year its global intangible low-taxed income (GILTI) in a manner generally similar to inclusions of subpart F income. GILTI means, with respect to any U.S. shareholder for the shareholder's taxable year, the excess (if any) of the shareholder's net CFC tested income over the shareholder's net deemed tangible income return.

Net deemed tangible income return is, with respect to any U.S. shareholder for a taxable year, the excess (if any) of 10 percent of the aggregate of its pro rata share of the qualified business asset investment (QBAI) of each CFC with respect to which it is a U.S. shareholder over the amount of interest expense taken into account in determining its net CFC tested income for the taxable year to the extent that the interest expense exceeds the interest income properly allocable to the interest expense that is taken into account in determining its net CFC tested income. As a result, the formula for GILTI in the provision is generally:[1365]

GILTI = Net CFC Tested Income — [(10% x *QBAI)* — *Interest Expense]*

where *Interest Expense* is defined and limited in the manner described above.

Calculation of Pro Rata Shares

For purposes of determining pro rata shares in the computation of a U.S. shareholder's GILTI amount, a person is treated as a U.S. shareholder of a CFC for any taxable year of such person only if the person owns (within the meaning of IRC section 958(a)) stock in the foreign corporation on the last day in the taxable year of the foreign corporation on which the foreign corporation is a CFC.

[1365] If the amount of interest expense exceeds 10% x QBAI, then the quantity in brackets in the formula equals zero in the determination of GILTI.

Net CFC Tested Income

Net CFC tested income means, with respect to any U.S. shareholder, the excess of the aggregate of the shareholder's pro rata share of the tested income of each CFC with respect to which it is a U.S. shareholder over the aggregate of its pro rata share of the tested loss of each CFC with respect to which it is a U.S. shareholder. Pro rata shares are determined under the rules of IRC section 951(a)(2).

The formula for net CFC tested income, which is calculated at the U.S. shareholder level, is:

Net CFC Tested Income = Sum of CFC Tested Income — Sum of CFC Tested Loss

The tested income of a CFC means the excess (if any) of the gross income of the corporation determined without regard to certain exceptions to tested income over deductions (including taxes) properly allocable to such gross income (referred to in this document as "tested gross income"). The exceptions to tested income are: (1) the corporation's ECI under IRC section 952(b); (2) any gross income taken into account in determining the corporation's subpart F income; (3) any gross income excluded from foreign base company income or insurance income by reason of the high-tax exception under IRC section 954(b)(4); (4) any dividend received from a related person (as defined in IRC section 954(d)(3)); and (5) any foreign oil and gas extraction income (as defined in IRC section 907(c)(1)).

The tested loss of a CFC means the excess (if any) of deductions (including taxes) properly allocable to the corporation's gross income determined without regard to the tested income exceptions over the amount of such gross income.

Computation of Tested Income and Tested Loss

For purposes of computing deductions (including taxes) properly allocable to gross income included in tested income or tested loss with respect to a CFC, the deductions are allocated to such gross income following rules similar to the rules of IRC section 954(b)(5) (or to which such deductions would be allocable if there were such gross income).

Qualified Business Asset Investment

QBAI means, with respect to any CFC for a taxable year, the average of the aggregate of its adjusted bases, determined as of the close of each quarter of the taxable year, in specified tangible property used in its trade or business and of a type with respect to which a deduction is generally allowable under IRC section 167. The adjusted basis in any property must be determined using the alternative depreciation system under current IRC section 168(g), notwithstanding any provision of law (or any other section of the provision) which is enacted after the date of enactment of this provision (unless such later enacted law specifically and directly amends this provision's definition).

Specified tangible property means any property used in the production of tested income.[1366] If such property was used in the production of both tested income and income that is not tested income (*i.e.*, dual-use property), the property is treated as specified tangible property in the same proportion that the amount of tested gross income produced with respect to the property bears to the total amount of gross income produced with respect to the property.[1367]

For purposes of determining a CFC's QBAI and its adjusted basis in specified tangible property, the adjusted basis is determined by allocating the depreciation deduction with respect to the property ratably to each day during the period in the taxable year to which the depreciation relates. In addition, if a CFC holds an interest in a partnership at the close of the CFC's taxable year, the CFC takes into account its distributive share of the aggregate of the partnership's adjusted bases (determined as of such date in the hands of the partnership) in tangible property held by the partnership to the extent that the property is used in the trade or business of the partnership, is of a type with respect to which a deduction is allowable under IRC section 167, and is used in the production of tested income (determined with respect to the CFC's distributive share of income with respect to the property). The CFC's distributive share of the adjusted basis of any property is the CFC's distributive share of income with respect to the property.

For purposes of determining QBAI, the Secretary is authorized to issue anti-avoidance regulations or other guidance as the Secretary determines appropriate, including regulations or other guidance that provide for the treatment of property if the property is transferred or held temporarily, or if avoidance was a factor in the transfer or holding of the property.

Coordination with Subpart F

Although GILTI inclusions do not constitute subpart F income, GILTI inclusions are generally treated similarly to subpart F inclusions. Thus they are generally treated in the same manner as amounts included under IRC section 951(a)(1)(A) for purposes of applying IRC sections 168(h)(2)(B), 535(b)(10), 904(h)(1), 959, 961, 962, 993(a)(1)(E), 996(f)(1), 1248(b)(1), 1248(d)(1), 6501(e)(1)(C), 6654(d)(2)(D), and 6655(e)(4). However, the Secretary may provide rules for coordinating the GILTI inclusion with provisions of law in which the determination of subpart F income is required to be made at the CFC level.

The provision requires that the amount of GILTI included by a U.S. shareholder be allocated across each CFC with respect to which it is a U.S. shareholder. The portion of GILTI treated as being with respect to a CFC equals zero for a CFC with no tested income and, for a CFC with tested income, the portion of GILTI which bears the same ratio to the total amount of GILTI as the U.S. shareholder's pro rata amount of tested income of the CFC bears to the aggregate amount of the U.S. shareholder's pro rata amount of the tested income of each CFC with respect to which it is a U.S. shareholder. For a CFC with tested income, the following formula expresses how to determine the portion of GILTI treated as being with respect to the CFC:

1366 Specified tangible property does not include property used in the production of tested loss, so that a CFC that has a tested loss in a taxable year does not have QBAI for the taxable year.

1367 For example, if a building produces $1,000 of tested gross income and $250 of subpart F income for a taxable year, then 80 percent (= $1,000/$1,250) of a domestic corporation's average adjusted basis in the building is included in QBAI for that taxable year.

CFC's GILTI = GILTI x *(Share of CFC'S Tested Income CFC Tested Income/Share of Agg. CFC Tested Income)*

where *Share of CFC's Tested Income* is the U.S. shareholder's pro rata amount of the tested income of a CFC and *Share of Agg. CFC Tested Income* is the aggregate amount of the U.S. shareholder's pro rata amount of the tested income of each CFC with respect to which it is a U.S. shareholder.

For purposes of the GILTI inclusion, a person is treated as a U.S. shareholder of a CFC for any taxable year only if such person owns (within the meaning of IRC section 958(a)) stock in the corporation on the last day, in such year, on which the corporation is a CFC. A corporation is generally treated as a CFC for any taxable year if the corporation is a CFC at any time during the taxable year.

Deemed-Paid Credit for Taxes Properly Attributable to Tested Income

For any amount of GILTI included in the gross income of a domestic corporation, the corporation's deemed-paid credit equals 80 percent of the product of the corporation's inclusion percentage multiplied by the aggregate tested foreign income taxes paid or accrued, with respect to tested income, by each CFC with respect to which the domestic corporation is a U.S. shareholder.

The inclusion percentage means, with respect to any domestic corporation, the ratio (expressed as a percentage) of such corporation's GILTI amount divided by the aggregate amount of its pro rata share of the tested income of each CFC with respect to which it is a U.S. shareholder (referred to as "aggregate tested income" in the formulas below). Tested foreign income taxes means, with respect to any domestic corporation that is a U.S. shareholder of a CFC, the foreign income taxes paid or accrued by the CFC that are properly attributable to the CFC's tested income.[1368]

The deemed-paid credit with respect to the GILTI inclusion can be expressed in the following formula:

$$\textit{Deemed-Paid Credit} = 80\% \times \frac{\text{GILTI}}{\textit{Aggregate Tested Income}} \times \textit{Aggregate Tested Foreign Income Tax}$$

The provision creates a separate foreign tax credit basket for GILTI, with no carryforward or carryback available for excess credits. For purposes of determining the foreign tax credit limitation, GILTI is not general category income, and income that is both GILTI and passive category income is considered passive category income. As described in new IRC section 78, the taxes deemed to have been paid are treated as an increase in GILTI for purposes of IRC section 78, determined by taking into account 100 percent of the product of the inclusion percentage and aggregate tested foreign income taxes (instead of 80 percent in the determination of the deemed-paid credit). Therefore, the IRC section 78 gross-up can be expressed in the following formula:

$$\textit{IRC section 78 Gross-Up} = 100\% \times \frac{\text{GILTI}}{} \times \textit{Aggregate Tested Foreign Income Tax}$$

[1368] Tested foreign income taxes do not include any foreign income tax paid or accrued by a CFC that is properly attributable to the CFC's tested loss (if any).

Aggregate Tested Income

Regulatory Authority to Address Abuse

The conferees intend that non-economic transactions intended to affect tax attributes of CFCs and their U.S. shareholders (including amounts of tested income and tested loss, tested foreign income taxes, net deemed tangible income return, and QBAI) to minimize tax under this provision be disregarded. For example, the conferees expect the Secretary to prescribe regulations to address transactions that occur after the measurement date of post-1986 earnings and profits under amended IRC section 965, but before the first taxable year for which new IRC section 951A applies, if such transactions are undertaken to increase a CFC's QBAI.

Effective Dates

The provision is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

California Law (R&TC sections 17024.5, 23051.5 and 25110)

IRC section 78, relating to dividends received from certain foreign corporations by domestic corporations choosing foreign tax credit, is not applicable for California purposes.

California does not allow a foreign tax credit.

California does not conform to subpart F (sections 951 to 965) of the IRC, relating to controlled foreign corporations, except to the extent applicable with respect to water's-edge elections.

Worldwide Unitary Method

California corporate taxpayers doing business both within and without California are required to compute their California franchise or income tax using the worldwide unitary method. Under this method, a corporate taxpayer's business income from both domestic and foreign unitary operations is considered in the calculation of the taxpayer's tax base, and a share of that business income is then "apportioned" to California using a formula. Income apportioned to California is subject to California franchise or income tax. The formula measures relative levels of business activity in the state by using the amount of the taxpayer's sales in California divided by the taxpayer's sales everywhere.[1369] This measure of activities is commonly called the "single sales-factor formula." The amount of sales from both domestic and foreign activities are included in the calculation of the apportionment formula. Generally, dividends paid from one member to another

[1369] An apportioning trade or business conducting certain qualified business activities is required to use an evenly weighted three-factor formula consisting of property, payroll, and sales to apportion its business income to California. (R&TC section 25128.)

within the unitary group from unitary earnings are eliminated from tax computations under R&TC section 25106.

California Water's-Edge Election

As an alternative to the worldwide unitary method, California law allows corporations to elect to determine the business income of their combined reporting group on a "water's-edge" basis. In general, the water’s-edge method excludes foreign corporations from the calculation of business income. An exception to this general rule is a controlled foreign corporation (CFC) with subpart F income. The income and factors of the CFC are included in a water's-edge combined report based on the CFC's inclusion ratio. The ratio is equal to the CFC’s current year subpart F income divided by the CFC’s current year earnings and profits. While California does not conform to the subpart F scheme of the IRC, for purposes of computing the CFC's inclusion ratio, California incorporates the federal definitions of "subpart F income" and "earnings and profits" as applicable for federal income tax purposes for the taxable year.[1370]

Generally dividends paid to the water's-edge combined reporting group from foreign affiliates are income on the water's-edge combined report. California taxpayers electing water's-edge treatment are generally entitled to a 75 percent dividends-received deduction on such dividends under R&TC section 24411.

Taxpayers can and do change their decision to elect water's-edge treatment. A taxpayer who elects water's-edge treatment must elect that treatment for seven years before they can terminate their election at their own discretion. A taxpayer who had terminated a water's-edge election and is thereafter using worldwide combined reporting treatment must wait seven years before they can re-elect for water's-edge treatment.

<u>Impact on California Revenue</u>

Not applicable.

[1370] R&TC section 25116. This is limited to provisions of the IRC referred to in the water’s edge election provisions that are not otherwise applicable for California franchise or income tax purposes.

Section	Section Title
14202	Deduction for Foreign-Derived Intangible Income and Global Intangible Low-Taxed Income

New Federal Law (IRC new section 250)

In General

The provision provides domestic corporations with reduced rates of U.S. tax on their foreign-derived intangible income (FDII) and global intangible low-taxed income (GILTI).[1371] GILTI is defined in new IRC section 951A, while a domestic corporation's FDII is the portion of its intangible income, determined on a formulaic basis that is derived from serving foreign markets.

Illustration of Effective Tax Rates on FDII and GILTI

Under a 21-percent corporate tax rate, and as a result of the deduction for FDII and GILTI, the effective tax rate on FDII is 13.125 percent and the effective U.S. tax rate on GILTI (with respect to domestic corporations) is 10.5 percent for taxable years beginning after December 31, 2017, and before January 1, 2026.[1372] Since only a portion (80 percent) of foreign tax credits are allowed to offset U.S. tax on GILTI, the minimum foreign tax rate, with respect to GILTI, at which no U.S. residual tax is owed by a domestic corporation is 13.125 percent.[1373] If the foreign tax rate on GILTI is zero percent, then the U.S. residual tax rate on GILTI is 10.5 percent. Therefore, as foreign tax rates on GILTI range between zero percent and 13.125 percent, the total combined foreign and U.S. tax rate on GILTI ranges between 10.5 percent and 13.125 percent. At foreign tax rates greater than or equal to 13.125 percent, there is no residual U.S. tax owed on GILTI, so that the combined foreign and U.S. tax rate on GILTI equals the foreign tax rate.

For domestic corporations in taxable years beginning after December 31, 2025, the effective tax rate on FDII is 16.406 percent and the effective U.S. tax rate on GILTI is 13.125 percent. The minimum foreign tax rate, with respect to GILTI, at which no U.S. residual tax is owed is 16.406 percent.[1374]

[1371] The deduction for FDII and GILTI is only available to domestic corporations. U.S. shareholders that are not domestic corporations are subject to full U.S. tax on their GILTI.

[1372] Due to the reduction in the effective U.S. tax rate resulting from the deduction for FDII and GILTI, the conferees expect the Secretary to provide, as appropriate, regulations or other guidance similar to that under amended IRC section 965 with respect to the determination of basis adjustments under IRC section 705(a)(1) and the determination of gain or loss under IRC section 986(c).

[1373] 13.125 percent equals the effective GILTI rate of 10.5 percent divided by 80 percent. If the foreign tax rate on GILTI is 13.125 percent, and domestic corporations are allowed a credit equal to 80 percent of foreign taxes paid, then the post-credit foreign tax rate on GILTI equals 10.5 percent (= 13.125 percent x 80 percent), which equals the effective GILTI rate of 10.5 percent. Therefore, no U.S. residual tax is owed.

[1374] If the foreign tax rate on GILTI is zero percent, then the U.S. residual tax rate on GILTI is 13.125 percent. Therefore, as foreign tax rates on GILTI range between zero percent and 16.406 percent, the total combined foreign and U.S. tax rate on GILTI ranges between 13.125 percent and 16.406 percent. At foreign tax rates greater than or equal to 16.406 percent, there is no residual U.S. tax on GILTI, and the combined foreign and U.S. tax rate on GILTI equals the foreign tax rate.

Deduction for FDII and GILTI

Deduction for FDII and GILTI and Taxable Income Limitation

In the case of domestic corporations for taxable years beginning after December 31, 2017, and before January 1, 2026, the provision generally allows as a deduction an amount equal to the sum of 37.5 percent of its FDII plus 50 percent of its GILTI (if any). For taxable years beginning after December 31, 2025, the deduction for FDII is reduced to 21.875 percent and the deduction for GILTI is lowered to 37.5 percent.[1375]

The deduction for FDII and GILTI is available only to C corporations that are not RICs or REITs.[1376]

The deduction for GILTI applies to the amount treated as a dividend received by a domestic corporation under IRC section 78 that is attributable to the corporation's GILTI amount under new IRC section 951A.

If the sum of a domestic corporation's FDII and GILTI amounts exceeds its taxable income determined without regard to this provision, then the amount of FDII and GILTI for which a deduction is allowed is reduced by an amount determined by such excess. The reduction in FDII for which a deduction is allowed equals such excess multiplied by a percentage equal to the corporation's FDII divided by the sum of its FDII and GILTI. The reduction in GILTI for which a deduction is allowed equals the remainder of such excess.[1377]

FDII

The FDII of any domestic corporation is the amount which bears the same ratio to the corporation's deemed intangible income as its foreign-derived deduction eligible income bears to its deduction eligible income. In other words, a domestic corporation's FDII is its deemed intangible income multiplied by the percentage of its deduction eligible income that is foreign-derived. The calculation can also be expressed as the following:

$$\text{FDII} = \text{Deemed Intangible Income} \times \frac{\text{Foreign-Derived Deduction Eligible Income}}{\text{Deduction Eligible Income}}$$

[1375] The Committee intends that the deduction allowed by new IRC section 250 be treated as exempting the deducted income from tax. Thus, for example, the deduction for global intangible low-taxed income could give rise to an increase in a domestic corporate partner's basis in a domestic partnership under IRC section 705(a)(1)(B).
[1376] An S corporation's taxable income is computed in the same manner as an individual (IRC section 1363(b)) so that deductions allowable only to corporations, such as FDII and GILTI, do not apply. See Report by the House Committee on Ways and Means to accompany H.R. 6055, Subchapter S Revision Act of 1982, H. Rep. No. 97-826, p. 14; and Report by the Senate Committee on Finance to accompany H.R. 6055, Subchapter S Revision Act of 1982, S. Rep. 97-640, p. 15. The IRC provides that deductions for corporations provided in part VIII of subchapter B, which include the deduction for FDII and GILTI, do not apply in computing investment company taxable income (IRC section 852(b)(2)(C)) or real estate investment trust taxable income (IRC section 857(b)(2)(A)). Therefore, the deduction for FDII and GILTI does not apply to RICs or REITs.
[1377] For example, consider a domestic corporation with $1,250 of FDII, $750 of GILTI, and taxable income (determined without regard to this provision) of $1,500. The sum of the corporation's FDII and GILTI amounts is $2,000, which exceeds $1,500 by $500. For purposes of this provision, the amount of FDII for which a deduction is allowed is reduced by $500 multiplied by $1,250/$2,000, or $312.50. The amount of GILTI for which a deduction is allowed is reduced by the remainder of the excess, or $187.50 (= $500 x $750/$2,000).

The Secretary is authorized to prescribe regulations or other guidance as may be necessary or appropriate to carry out this provision.

Deduction Eligible Income

Deduction eligible income means, with respect to any domestic corporation, the excess (if any) of the gross income of the corporation determined without regard to certain exceptions to deduction eligible income over deductions (including taxes) properly allocable to such gross income (referred to in this document as ‘‘deduction eligible gross income"). The exceptions to deduction eligible income are: (1) the subpart F income of the corporation determined under IRC section 951; (2) the GILTI of the corporation; (3) any financial services income (as defined in IRC section 904(d)(2)(D)) of the corporation; (4) any dividend received from a CFC with respect to which the corporation is a U.S. shareholder; and (5) any domestic oil and gas extraction income of the corporation; and (6) any foreign branch income (as defined in IRC section 904(d)(2)(J)) of the corporation.

The formula for deduction eligible income can generally be written as follows: [1378]

Deduction Eligible Income = Gross Income – Exceptions – Allocable Deductions

where Exceptions refers to the exceptions to deduction eligible income and Allocable Deductions encompass all deductions (including taxes) property allocable to deduction eligible gross income.

Deemed Intangible Income

The domestic corporation's deemed intangible income means the excess (if any) of its deduction eligible income over its deemed tangible income return. The deemed tangible income return means, with respect to any corporation, an amount equal to 10 percent of the corporation's qualified business asset investment (QBAI).

Deemed intangible income can be calculated as follows:[1379]

Deemed Intangible Income = Deduction Eligible Income — (10% x QBAI)

For purposes of computing its FDII, a domestic corporation's QBAI is the average of the aggregate of its adjusted bases, determined as of the close of each quarter of the taxable year, in specified tangible property used in its trade or business and of a type with respect to which a deduction is allowable under IRC section 167. The adjusted basis in any property must be determined using the alternative depreciation system under IRC section 168(g), notwithstanding any provision of law (or any other section of the provision) which is enacted after the date of enactment of this

[1378] This formula assumes that the excess described in the preceding paragraph is positive. Otherwise there is no deduction eligible income.
[1379] If the quantity in this formula is negative, deemed intangible income is zero.

provision (unless such later enacted law specifically and directly amends this provision's definition).

Specified tangible property means any tangible property used in the production of deduction eligible income. If such property was used in the production of deduction eligible income and income that is not deduction eligible income (*i.e.*, dual-use property), the property is treated as specified tangible property in the same proportion that the amount of deduction eligible gross income produced with respect to the property bears to the total amount of gross income produced with respect to the property.[1380] In other words, the percentage of a domestic corporation's adjusted basis in dual-use property that is included in QBAI equals the deduction eligible gross income produced with respect to the property divided by the total gross income produced with respect to the property.

Foreign-Derived Deduction Eligible Income

Foreign-derived deduction eligible income means, with respect to a taxpayer for its taxable year, any deduction eligible income of the taxpayer that is derived in connection with (1) property that is sold by the taxpayer to any person who is not a United States person and that the taxpayer establishes to the satisfaction of the Secretary is for a foreign use[1381] or (2) services provided by the taxpayer that the taxpayer establishes to the satisfaction of the Secretary are provided to any person, or with respect to property, not located within the United States. Foreign use means any use, consumption, or disposition that is not within the United States. Special rules for determining foreign use apply to transactions that involve property or services provided to domestic intermediaries or related parties.

For purposes of the provision, the terms “sold,” “sells”, and “sale” include any lease, license, exchange, or other disposition.

Property or services provided to domestic intermediaries

If a taxpayer sells property to another person (other than a related party) for further manufacture or modification within the United States, the property is generally not treated as sold for a foreign use even if such other person subsequently uses such property for foreign use. However, there is an exception to this general rule for property (1) that is ultimately sold by a related party, or used by a related party in connection with property that is sold or the provision of services, to another person who is an unrelated party who is not a U.S. person, and (2) that the taxpayer establishes to the satisfaction of the Secretary is for a foreign use.[1382] Deduction eligible income derived in

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[1380] For example, if a building is used in the production of $1,000 of total gross income for a taxable year, $250 of which was domestic oil and gas extraction income and the remaining $750 of which was deduction eligible gross income, then 75 percent of a domestic corporation's average adjusted basis in the building is included in QBAI for that taxable year.

[1381] If property is sold by a taxpayer to a person who is not a U.S. person, and after such sale the property is subject to manufacture, assembly, or other processing (including the incorporation of such property, as a component, into a second product by means of production, manufacture, or assembly) outside the United States by such person, then the property is for a foreign use.

[1382] In other words, the fact that a component is included in a piece of property that is eventually sold for a foreign use is insufficient for the sale of the component to be considered for a foreign use.

connection with services provided to another person (other than a related party) located within the United States is not treated as foreign-derived deduction eligible income, even if the other person uses the services in providing services the income from which is considered foreign-derived deduction eligible income.

Special Rules with Respect to Related Party Transactions

If property is sold to a related foreign party, the sale is not treated as for a foreign use unless the property is sold by the related foreign party to another person who is unrelated and is not a U.S. person and the taxpayer establishes to the satisfaction of the Secretary that such property is for a foreign use. Income derived in connection with services provided to a related party who is not located in the United States is not treated as foreign-derived deduction eligible income unless the taxpayer establishes to the satisfaction of the Secretary that such service is not substantially similar to services provided by the related party to persons located within the United States. For purposes of applying these rules, a related party means any member of an affiliated group as defined in IRC section 1504(a) determined by substituting "more than 50 percent" for "at least 80 percent" each place it appears and without regard to IRC sections 1504(b)(2) and 1504(b)(3). Any person (other than a corporation) is treated as a member of the affiliated group if the person is controlled by members of the group (including any entity treated as a member of the group by reason of this sentence) or controls any member, with control being determined under the rules of IRC section 954(d)(3).

Effective Dates

The provision is effective for taxable years beginning after December 31, 2017.

California Law (R&TC sections 24411, 25106, and 25110)

California does not conform to subpart F (sections 951 to 965) of the IRC, relating to controlled foreign corporations, except to the extent applicable with respect to water's-edge elections.

Worldwide Unitary Method

California corporate taxpayers doing business both within and without California are required to compute their California franchise or income tax using the worldwide unitary method. Under this method, a corporate taxpayer's business income from both domestic and foreign unitary operations is considered in the calculation of the taxpayer's tax base, and a share of that business income is then "apportioned" to California using a formula. Income apportioned to California is subject to California franchise or income tax. The formula measures relative levels of business activity in the state by using the amount of the taxpayer's sales in California divided by the taxpayer's sales everywhere.[1383] This measure of activities is commonly called the "single sales-factor formula." The amount of sales from both domestic and foreign activities are included in the

[1383] An apportioning trade or business conducting certain qualified business activities is required to use an evenly weighted three-factor formula consisting of property, payroll, and sales to apportion its business income to California. (R&TC section 25128.)

calculation of the apportionment formula. Generally, dividends paid from one member to another within the unitary group from unitary earnings are eliminated from tax computations under R&TC section 25106.

California Water's-Edge Election

As an alternative to the worldwide unitary method, California law allows corporations to elect to determine the business income of their combined reporting group on a "water's-edge" basis. In general, the water's-edge method excludes foreign corporations from the calculation of business income. An exception to this general rule is a controlled foreign corporation (CFC) with subpart F income. The income and factors of the CFC are included in a water's-edge combined report based on the CFC's inclusion ratio. The ratio is equal to the CFC's current year subpart F income divided by the CFC's current year earnings and profits. While California does not conform to the subpart F scheme of the IRC, for purposes of computing the CFC's inclusion ratio, California incorporates the federal definitions of "subpart F income" and "earnings and profits" as applicable for federal income tax purposes for the taxable year.[1384]

Generally dividends paid to the water's-edge combined reporting group from foreign affiliates are income on the water's-edge combined report. California taxpayers electing water's-edge treatment are generally entitled to a 75 percent dividends-received deduction on such dividends under R&TC section 24411.

Taxpayers can and do change their decision to elect water's-edge treatment. A taxpayer who elects water's-edge treatment must elect that treatment for seven years before they can terminate their election at their own discretion. A taxpayer who had terminated a water's-edge election and is thereafter using worldwide combined reporting treatment must wait seven years before they can re-elect for water's-edge treatment.

<u>Impact on California Revenue</u>

Not applicable.

[1384] R&TC section 25116. This is limited to provisions of the IRC referred to in the water's edge election provisions that are not otherwise applicable for California franchise or income tax purposes.

Chapter 2—Other Modifications of Subpart F Provisions

Section	Section Title
14211	Elimination of Inclusion of Foreign Base Company Oil Related Income

New Federal Law (IRC section 954(a))

The provision eliminates foreign base company oil related income as a category of foreign base company income.

Effective Dates

The provision is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

California Law (R&TC section 25110)

California does not conform to subpart F (sections 951 to 965) of the IRC, relating to controlled foreign corporations, except to the extent applicable with respect to water's-edge elections.

Worldwide Unitary Method

California corporate taxpayers doing business both within and without California are required to compute their California franchise or income tax using the worldwide unitary method. Under this method, a corporate taxpayer's business income from both domestic and foreign unitary operations is considered in the calculation of the taxpayer's tax base, and a share of that business income is then "apportioned" to California using a formula. Income apportioned to California is subject to California franchise or income tax. The formula measures relative levels of business activity in the state by using the amount of the taxpayer's sales in California divided by the taxpayer's sales everywhere.[1385] This measure of activities is commonly called the "single sales-factor formula." The amount of sales from both domestic and foreign activities are included in the calculation of the apportionment formula. Generally, dividends paid from one member to another within the unitary group from unitary earnings are eliminated from tax computations under R&TC section 25106.

California Water's-Edge Election

As an alternative to the worldwide unitary method, California law allows corporations to elect to determine the business income of their combined reporting group on a "water's-edge" basis. In general, the water's-edge method excludes foreign corporations from the calculation of business

[1385] An apportioning trade or business conducting certain qualified business activities is required to use an evenly weighted three-factor formula consisting of property, payroll, and sales to apportion its business income to California. (R&TC section 25128.)

income. An exception to this general rule is a controlled foreign corporation (CFC) with subpart F income. The income and factors of the CFC are included in a water's-edge combined report based on the CFC's inclusion ratio. The ratio is equal to the CFC's current year subpart F income divided by the CFC's current year earnings and profits.

While California does not conform to the subpart F scheme of the IRC, for purposes of computing the CFC's inclusion ratio, California incorporates the federal definitions of "subpart F income" and "earnings and profits" as applicable for federal income tax purposes for the taxable year. This is limited to provisions of the IRC referred to in the water's-edge election provisions that are not otherwise applicable for California franchise or income tax purposes.

R&TC section 25110 specifically refers to "subpart F income" as defined in IRC section 952. IRC section 952 defines "subpart F income" to include foreign base company income, as determined under IRC section 954. As a result, the elimination of foreign base company oil related income as a category of foreign base company income is applicable with respect to water's-edge elections for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

Impact on California Revenue

Baseline.

Section	Section Title
14212	Repeal of Inclusion Based on Withdrawal of Previously Excluded Subpart F Income from Qualified Investment

New Federal Law (IRC section 955)

The provision repeals IRC section 955. As a result, a U.S. shareholder in a CFC that invested its previously excluded subpart F income in qualified foreign base company shipping operations is no longer required to include in income a pro rata share of the previously excluded subpart F income when the CFC decreases such investments.

Effective Dates

The provision applies to taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end.

California Law (R&TC section 25110)

California does not conform to subpart F (sections 951 to 965) of the IRC, relating to controlled foreign corporations, except to the extent applicable with respect to water's-edge elections.

Worldwide Unitary Method

California corporate taxpayers doing business both within and without California are required to compute their California franchise or income tax using the worldwide unitary method. Under this method, a corporate taxpayer's business income from both domestic and foreign unitary operations is considered in the calculation of the taxpayer's tax base, and a share of that business income is then "apportioned" to California using a formula. Income apportioned to California is subject to California franchise or income tax. The formula measures relative levels of business activity in the state by using the amount of the taxpayer's sales in California divided by the taxpayer's sales everywhere.[1386] This measure of activities is commonly called the "single sales-factor formula." The amount of sales from both domestic and foreign activities are included in the calculation of the apportionment formula. Generally, dividends paid from one member to another within the unitary group from unitary earnings are eliminated from tax computations under R&TC section 25106.

California Water's-Edge Election

As an alternative to the worldwide unitary method, California law allows corporations to elect to determine the business income of their combined reporting group on a "water's-edge" basis. In general, the water's-edge method excludes foreign corporations from the calculation of business income. An exception to this general rule is a controlled foreign corporation (CFC) with subpart F income. The income and factors of the CFC are included in a water's-edge combined report based on the CFC's inclusion ratio. The ratio is equal to the CFC's current year subpart F income divided by the CFC's current year earnings and profits. While California does not conform to the subpart F scheme of the IRC, for purposes of computing the CFC's inclusion ratio, California incorporates the federal definitions of "subpart F income" and "earnings and profits" as applicable for federal income tax purposes for the taxable year.[1387]

Generally dividends paid to the water's-edge combined reporting group from foreign affiliates are income on the water's-edge combined report. California taxpayers electing water's-edge treatment are generally entitled to a 75 percent dividends-received deduction on such dividends under R&TC section 24411.

Taxpayers can and do change their decision to elect water's-edge treatment. A taxpayer who elects water's-edge treatment must elect that treatment for seven years before they can terminate

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[1386] An apportioning trade or business conducting certain qualified business activities is required to use an evenly weighted three-factor formula consisting of property, payroll, and sales to apportion its business income to California. (R&TC section 25128.)

[1387] R&TC section 25116. This is limited to provisions of the IRC referred to in the water's edge election provisions that are not otherwise applicable for California franchise or income tax purposes.

their election at their own discretion. A taxpayer who had terminated a water's-edge election and is thereafter using worldwide combined reporting treatment must wait seven years before they can re-elect for water's-edge treatment.

Impact on California Revenue

Baseline.

Section	Section Title
14213	Modification of Stock Attribution Rules for Determining Status as a Controlled Foreign Corporation

New Federal Law (IRC section 958)

The provision amends the ownership attribution rules of IRC section 958(b) so that certain stock of a foreign corporation owned by a foreign person is attributed to a related U.S. person for purposes of determining whether the related U.S. person is a U.S. shareholder of the foreign corporation and, therefore, whether the foreign corporation is a CFC. In other words, the provision provides “downward attribution” from a foreign person to a related U.S. person in circumstances in which prior law does not so provide. The pro rata share of a CFC's subpart F income that a U.S. shareholder is required to include in gross income, however, continues to be determined based on direct or indirect ownership of the CFC, without application of the new downward attribution rule.

The provision is not intended to cause a foreign corporation to be treated as a controlled foreign corporation with respect to a U.S. shareholder as a result of attribution of ownership under IRC section 318(a)(3) to a U.S. person that is not a related person (within the meaning of IRC section 954(d)(3)) to such U.S. shareholder as a result of the repeal of IRC section 958(b)(4).[1388]

In adopting this provision, the conferees intend to render ineffective certain transactions that are used as a means of avoiding the subpart F provisions. One such transaction involves effectuating “de-control” of a foreign subsidiary, by taking advantage of the IRC section 958(b)(4) rule that effectively turns off the constructive stock ownership rules of IRC section 318(a)(3) when to do otherwise would result in a U.S. person being treated as owning stock owned by a foreign person. Such a transaction converts former CFCs to non-CFCs, despite continuous ownership by U.S. shareholders.

Effective Dates

The provision is effective for the last taxable year of foreign corporations beginning before

[1388] Committee Print, *Reconciliation Recommendations Pursuant to H. Con. Res. 71,* S. Prt. 115-20, (December 2017), p. 378, as reprinted on the website of the Senate Budget Committee, available at *https://www.budget.senate.gov/taxreform.*

January 1, 2018, and each subsequent year of such foreign corporations and for the taxable years of U.S. shareholders in which or within which such taxable years of foreign corporations end.

California Law (R&TC section 25110)

California does not conform to subpart F (sections 951 to 965) of the IRC, relating to controlled foreign corporations, except to the extent applicable with respect to water's edge elections.

Worldwide Unitary Method

California corporate taxpayers doing business both within and without California are required to compute their California franchise or income tax using the worldwide unitary method. Under this method, a corporate taxpayer's business income from both domestic and foreign unitary operations is considered in the calculation of the taxpayer's tax base, and a share of that business income is then "apportioned" to California using a formula. Income apportioned to California is subject to California franchise or income tax. The formula measures relative levels of business activity in the state by using the amount of the taxpayer's sales in California divided by the taxpayer's sales everywhere.[1389] This measure of activities is commonly called the "single sales-factor formula." The amount of sales from both domestic and foreign activities are included in the calculation of the apportionment formula. Generally, dividends paid from one member to another within the unitary group from unitary earnings are eliminated from tax computations under R&TC section 25106.

California Water's-Edge Election

As an alternative to the worldwide unitary method, California law allows corporations to elect to determine the business income of their combined reporting group on a "water's-edge" basis. In general, the water's-edge method excludes foreign corporations from the calculation of business income. An exception to this general rule is a controlled foreign corporation (CFC) with subpart F income. The income and factors of the CFC are included in a water's-edge combined report based on the CFC's inclusion ratio. The ratio is equal to the CFC's current year subpart F income divided by the CFC's current year earnings and profits. While California does not conform to the subpart F scheme of the IRC, for purposes of computing the CFC's inclusion ratio, California incorporates the federal definitions of "subpart F income" and "earnings and profits" as applicable for federal income tax purposes for the taxable year.[1390]

While California does not conform to the subpart F scheme of the IRC, for purposes of applying the CFC inclusion provision, California incorporates the federal definition of "controlled foreign corporation" as applicable for federal income tax purposes for the taxable year. This is limited to

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[1389] An apportioning trade or business conducting certain qualified business activities is required to use an evenly weighted three-factor formula consisting of property, payroll, and sales to apportion its business income to California. (R&TC section 25128.)

[1390] R&TC section 25116. This is limited to provisions of the IRC referred to in the water's edge election provisions that are not otherwise applicable for California franchise or income tax purposes.

provisions of the IRC referred to in the water's-edge election provisions that are not otherwise applicable for California franchise or income tax purposes.

R&TC section 25110 specifically refers to "controlled foreign corporation" as defined in IRC section 957. IRC section 957 applies the stock ownership rules under IRC section 958 to determine if a foreign corporation meets the U.S. shareholder ownership requirement to be a controlled foreign corporation. As a result, the new ownership attribution rule is applicable with respect to water's-edge elections for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. shareholders in which or within which such taxable years of foreign corporations end.

Impact on California Revenue

Baseline.

Section	Section Title
14214	Modification of Definition of United States Shareholder

New Federal Law (IRC section 951)

The provision expands the definition of U.S. shareholder under subpart F to include any U.S. person who owns 10 percent or more of the total value of shares of all classes of stock of a foreign corporation.

Effective Dates

The provision is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

California Law (R&TC section 25110)

California does not conform to subpart F (sections 951 to 965) of the IRC, relating to controlled foreign corporations, except to the extent applicable with respect to water's-edge elections.

Worldwide Unitary Method

California corporate taxpayers doing business both within and without California are required to compute their California franchise or income tax using the worldwide unitary method. Under this method, a corporate taxpayer's business income from both domestic and foreign unitary operations is considered in the calculation of the taxpayer's tax base, and a share of that business income is then “apportioned” to California using a formula. Income apportioned to California is subject to California franchise or income tax. The formula measures relative levels of business activity in the state by using the amount of the taxpayer's sales in California divided by the taxpayer's sales everywhere.[1391] This measure of activities is commonly called the "single sales-factor formula." The amount of sales from both domestic and foreign activities are included in the calculation of the apportionment formula. Generally, dividends paid from one member to another within the unitary group from unitary earnings are eliminated from tax computations under R&TC section 25106.

California Water's-Edge Election

As an alternative to the worldwide unitary method, California law allows corporations to elect to determine the business income of their combined reporting group on a "water's-edge" basis. In general, the water's-edge method excludes foreign corporations from the calculation of business income. An exception to this general rule is a controlled foreign corporation (CFC) with subpart F income. The income and factors of the CFC are included in a water's-edge combined report based on the CFC's inclusion ratio. The ratio is equal to the CFC's current year subpart F income divided by the CFC's current year earnings and profits. While California does not conform to the subpart F scheme of the IRC, for purposes of computing the CFC's inclusion ratio, California incorporates the federal definitions of "subpart F income" and "earnings and profits" as applicable for federal income tax purposes for the taxable year.[1392]

Generally dividends paid to the water's-edge combined reporting group from foreign affiliates are income on the water's-edge combined report. California taxpayers electing water's-edge treatment are generally entitled to a 75 percent dividends-received deduction on such dividends under R&TC section 24411.

Taxpayers can and do change their decision to elect water's-edge treatment. A taxpayer who elects water's-edge treatment must elect that treatment for seven years before they can terminate their election at their own discretion. A taxpayer who had terminated a water's-edge election and is thereafter using worldwide combined reporting treatment must wait seven years before they can re-elect for water's-edge treatment.

Impact on California Revenue

Baseline.

[1391] An apportioning trade or business conducting certain qualified business activities is required to use an evenly weighted three-factor formula consisting of property, payroll, and sales to apportion its business income to California. (R&TC section 25128.)

[1392] R&TC section 25116. This is limited to provisions of the IRC referred to in the water's edge election provisions that are not otherwise applicable for California franchise or income tax purposes.

Section	Section Title
14215	Elimination of Requirement That Corporation Must Be Controlled for 30 Days Before Subpart F Inclusions Apply

New Federal Law (IRC section 951(a)(1))

The provision eliminates the requirement that a corporation must be controlled for an uninterrupted period of 30 days before subpart F inclusions apply.

Effective Dates

The provision is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. shareholders with or within which such taxable years of foreign corporations end.

California Law (R&TC section 25110)

California does not conform to subpart F (sections 951 to 965) of the IRC, relating to controlled foreign corporations, except to the extent applicable with respect to water's-edge elections.

Worldwide Unitary Method

California corporate taxpayers doing business both within and without California are required to compute their California franchise or income tax using the worldwide unitary method. Under this method, a corporate taxpayer's business income from both domestic and foreign unitary operations is considered in the calculation of the taxpayer's tax base, and a share of that business income is then "apportioned" to California using a formula. Income apportioned to California is subject to California franchise or income tax. The formula measures relative levels of business activity in the state by using the amount of the taxpayer's sales in California divided by the taxpayer's sales everywhere.[1393] This measure of activities is commonly called the "single sales-factor formula." The amount of sales from both domestic and foreign activities are included in the calculation of the apportionment formula. Generally, dividends paid from one member to another within the unitary group from unitary earnings are eliminated from tax computations under R&TC section 25106.

California Water's-Edge Election

As an alternative to the worldwide unitary method, California law allows corporations to elect to determine the business income of their combined reporting group on a "water's-edge" basis. In general, the water's-edge method excludes foreign corporations from the calculation of business income. An exception to this general rule is a controlled foreign corporation (CFC) with subpart F income. The income and factors of the CFC are included in a water's-edge combined report based

[1393] An apportioning trade or business conducting certain qualified business activities is required to use an evenly weighted three-factor formula consisting of property, payroll, and sales to apportion its business income to California. (R&TC section 25128.)

on the CFC's inclusion ratio. The ratio is equal to the CFC's current year subpart F income divided by the CFC's current year earnings and profits. While California does not conform to the subpart F scheme of the IRC, for purposes of computing the CFC's inclusion ratio, California incorporates the federal definitions of "subpart F income" and "earnings and profits" as applicable for federal income tax purposes for the taxable year.[1394]

Generally dividends paid to the water's-edge combined reporting group from foreign affiliates are income on the water's-edge combined report. California taxpayers electing water's-edge treatment are generally entitled to a 75 percent dividends-received deduction on such dividends under R&TC section 24411.

Taxpayers can and do change their decision to elect water's-edge treatment. A taxpayer who elects water's-edge treatment must elect that treatment for seven years before they can terminate their election at their own discretion. A taxpayer who had terminated a water's-edge election and is thereafter using worldwide combined reporting treatment must wait seven years before they can re-elect for water's-edge treatment.

Impact on California Revenue

Baseline.

Chapter 3—Prevention of Base Erosion

Section	Section Title
14221	Limitations on Income Shifting Through Intangible Property Transfers

New Federal Law (IRC sections 367, 482, and 936)

The provision addresses recurring definitional and methodological issues that have arisen in controversies[1395] in transfers of intangible property for purposes of IRC sections 367(d) and 482, both of which use the statutory definition of intangible property in IRC section 936(h)(3)(B). The provision revises that definition and confirms the authority to require certain valuation methods. It does not modify the basic approach of the existing transfer pricing rules with regard to income from intangible property.

[1394] R&TC section 25116. This is limited to provisions of the IRC referred to in the water's edge election provisions that are not otherwise applicable for California franchise or income tax purposes.
[1395] *Veritas v. Commissioner,* 133 T.C. No. 14 (December 10, 2009), *non-acq.,* IRB 2010-49 (December 6, 2010). (stating that including goodwill and going concern value within the definition would "expand[]" that definition, and that ''taxpayers are merely required to be compliant, not prescient"); *Amazon v. Commissioner*, 148 T.C. No. 8 (2017) (holding that ''workforce in place, going concern value, goodwill, and what trial witnesses described as 'growth options' and corporate 'resources' or 'opportunities' " all fell outside the definition under prior law).

Under the provision, workforce in place, goodwill (both foreign and domestic), and going concern value are intangible property within the meaning of IRC section 936(h)(3)(B), as is the residual category of "any similar item" the value of which is not attributable to tangible property or the services of an individual. The flush language at the end of that subparagraph is removed, to make clear that the source or amount of value is not relevant to whether property that is one of the specified types of intangible property is within the scope of the definition.

The provision clarifies the authority of the Secretary to specify the method to be used to determine the value of intangible property, both with respect to outbound restructurings of U.S. operations and to intercompany pricing allocations,[1396] by amending IRC section 482 as well as the grant of regulatory authority under IRC section 367 regarding the use of aggregate basis valuation and the application of the realistic alternative principle.

With respect to aggregate basis valuation, the provision requires use of that method of valuation in the case of transfers of multiple intangible properties in one or more related transactions if the Secretary determines that an aggregate basis achieves a more reliable result than an asset-by-asset approach. The provision is consistent with the position that the additional value that results from the interrelation of intangible assets can be properly attributed to the underlying intangible assets in the aggregate, where doing so yields a more reliable result. This approach is also consistent with Tax Court decisions in cases outside of the IRC section 482 context, where collections of multiple, related intangible assets were viewed by the Tax Court in the aggregate.[1397] Finally, it is also consistent with the cost-sharing regulations.[1398]

The provision codifies use of the realistic alternative principles to determine valuation with respect to intangible property transactions. The realistic alternative principle is predicated on the notion that a taxpayer will only enter into a particular transaction if none of its realistic alternatives is economically preferable to the transaction under consideration. For example, under the existing regulations provide the IRS with the ability to determine an arm's-length price by reference to a transaction (such as the owner of intangible property using it to make a product itself) that is different from the transaction that was actually completed (such as the owner of that same intangible property licensing the manufacturing rights and then buying the product from the licensee).

[1396] IRC sections 367(d) and 482.
[1397] *See, e.g., Kraft Foods Co. v. Commissioner*, 21 T.C. 513 (1954) (thirty-one related patents must be valued as a group and the useful life for depreciation should be based on the average of the patents' useful lives); *Standard Conveyor Co. v. Commissioner*, 25 B.T.A. 281, p. 283 (1932) (''[I]t is evident that it is impossible to value these seven patents separately. Their value, as in the case of many groups of patents representing improvements on the prior art, appears largely to consist of their combination."); *Massey-Ferguson, Inc. v. Commissioner*, 59 T.C. 220 (1972) (taxpayer who abandoned a distribution network of contracts with separate distributorships was entitled to an abandonment loss for the entire network in the taxable year during which the last of the contracts was terminated because that was the year in which the entire intangible value was lost).
[1398] See Treasury Regulation section 1.482-7(g)(2)(iv) (if multiple transactions in connection with a costsharing arrangement involve platform, operating and other contributions of resources, capabilities or rights that are reasonably anticipated to be interrelated, then determination of the arm's-length charge for platform contribution transactions and other transactions on an aggregate basis may provide the most reliable measure of an arm's-length result).

Effective Dates

The provision applies to transfers in taxable years beginning after December 31, 2017. No inference is intended with respect to application of IRC section 936(h)(3) or the authority of the Secretary to provide by regulation for such application with respect to taxable years beginning before January 1, 2018.

California Law R&TC sections 17024.5, 17321, 17551, 24451 and 24725)

California conforms by reference to IRC section 367, relating to foreign corporations, in R&TC sections 17321, 17024.5(b)(9), and 24451, as of the "specified date" of January 1, 2015.

California conforms by reference to IRC section 482, relating to allocation of income and deductions among taxpayers, in R&TC sections 17551 and 24725, with exceptions, as of the "specified date" of January 1, 2015.

California does not conform to IRC section 936, relating to Puerto Rico and possession tax credit.

Impact on California Revenue

Estimated Conformity Revenue Impact of Limitations on Income Shifting Through Intangible Property Transfers For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	$5,400,000	$3,900,000	$3,500,000

Section	Section Title
14222	Certain Related Party Amounts Paid or Accrued In Hybrid Transactions or With Hybrid Entities

New Federal Law (IRC new section 267A)

The provision denies a deduction for any disqualified related party amount paid or accrued pursuant to a hybrid transaction or by, or to, a hybrid entity. A disqualified related party amount is any interest or royalty paid or accrued to a related party to the extent that: (1) there is no corresponding inclusion to the related party under the tax law of the country of which such related party is a resident for tax purposes or is subject to tax, or (2) such related party is allowed a deduction with respect to such amount under the tax law of such country. A disqualified related party amount does not include any payment to the extent such payment is included in the gross income of a U.S. shareholder under IRC section 951(a). A related party for these purposes is determined under the rules of IRC section 954(d)(3), except that such section applies with respect to the payor as opposed to the CFC otherwise referred to in such section.

A hybrid transaction is any transaction, series of transactions, agreement, or instrument one or more payments with respect to which are treated as interest or royalties for Federal income tax purposes and which are not so treated for purposes of the tax law of the foreign country of which the recipient of such payment is resident for tax purposes or is subject to tax. A hybrid entity is any entity which is either: (1) treated as fiscally transparent for Federal income tax purposes but not so treated for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or is subject to tax, or (2) treated as fiscally transparent for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or is subject to tax but not so treated for Federal income tax purposes.

The provision further provides that the Secretary shall issue regulations or other guidance as may be necessary or appropriate to carry out the purposes of the provision, including regulations or other guidance providing rules for: (1) denying deductions for conduit arrangements that involve a hybrid transaction or a hybrid entity, (2) the application of this provision to foreign branches, (3) applying this provision to certain structured transactions, (4) denying all or a portion of a deduction claimed for an interest or a royalty payment that, as a result of the hybrid transaction or entity, is included in the recipient's income under a preferential tax regime of the country of residence of the recipient and has the effect of reducing the country's generally applicable statutory tax rate by at least 25 percent, (5) denying all of a deduction claimed for an interest or a royalty payment if such amount is subject to a participation exemption system or other system which provides for the exclusion or deduction of a substantial portion of such amount, (6) rules for determining the tax residence of a foreign entity if the foreign entity is otherwise considered a resident of more than one country or of no country, (7) exceptions to the general rule set forth in the provision, and (8) requirements for record keeping and information in addition to any requirements imposed by IRC section 6038A.

The provision also provides that the Secretary shall issue regulations or other guidance as may be necessary or appropriate to carry out the purposes of the provision for branches (domestic or foreign) and domestic entities, even if such branches or entities do not meet the statutory definition of a hybrid entity.

Effective Dates

The provision shall apply to taxable years beginning after December 31, 2017.

California Law (R&TC sections 17201 to 17299.9 and sections 24421 to 24429)

California conforms to various provisions of Part IX of Subchapter B of Chapter 1 of Subtitle A (sections 261 to 280H) of the IRC, relating to items not deductible, with exceptions, additions, and modifications, as of the “specified date” of January 1, 2015.

Impact on California Revenue

Not applicable.

Section	Section Title
14223	Shareholders of Surrogate Foreign Corporations Not Eligible for Reduced Rate on Dividends

New Federal Law (IRC section 1)

Any individual shareholder who receives a dividend from a corporation which is a surrogate foreign corporation as defined in IRC section 7874(a)(2)(B), other than a foreign corporation which is treated as a domestic corporation under IRC section 7874(b), is not entitled to the lower rates on qualified dividends provided for in IRC section 1(h).

The provision applies to dividends received from foreign corporations that first become surrogate foreign corporations after date of enactment.

Effective Dates

The provision is effective for dividends received after December 22, 2017.

California Law (R&TC section 17041)

Under current California law, dividends received by an individual are taxed at ordinary income tax rates.

Impact on California Revenue

Not applicable.

Subpart C—Modifications Related to Foreign Tax Credit System

Background

Foreign Tax Credit

Subject to certain limitations, U.S. citizens, resident individuals, and domestic corporations are allowed to claim credit for foreign income taxes they pay. A domestic corporation that owns at least 10 percent of the voting stock of a foreign corporation is allowed a "deemed-paid" credit for foreign income taxes paid by the foreign corporation that the domestic corporation is deemed to have paid when the related income is distributed as a dividend or is included in the domestic corporation's income under the anti-deferral rules.[1399]

The foreign tax credit generally is limited to a taxpayer's U.S. tax liability on its foreign-source taxable income (as determined under U.S. tax accounting principles). This limit is intended to ensure that the credit serves its purpose of mitigating double taxation of foreign-source income without offsetting U.S. tax on U.S.-source income.[1400] The limit is computed by multiplying a taxpayer's total U.S. tax liability for the year by the ratio of the taxpayer's foreign-source taxable income for the year to the taxpayer's total taxable income for the year. If the total amount of foreign income taxes paid and deemed paid for the year exceeds the taxpayer's foreign tax credit limitation for the year, the taxpayer may carry back the excess foreign taxes to the previous year or carry forward the excess taxes to one of the succeeding 10 years.[1401]

The computation of the foreign tax credit limitation requires a taxpayer to determine the amount of its taxable income from foreign sources in each limitation category (described below) by allocating and apportioning deductions between U.S.-source gross income, on the one hand, and foreign-source gross income in each limitation category, on the other. In general, deductions are allocated and apportioned to the gross income to which the deductions factually relate.[1402] However, subject to certain exceptions, deductions for interest expense and research and experimental expenses are apportioned based on taxpayer ratios.[1403] In the case of interest expense, this ratio is the ratio of the corporation's foreign or domestic (as applicable) assets to its worldwide assets. In the case of research and experimental expenses, the apportionment ratio is based on either sales or gross income. All members of an affiliated group of corporations generally are treated as a single corporation for purposes of determining the apportionment ratios.[1404]

The term "affiliated group" is determined generally by reference to the rules for determining whether corporations are eligible to file consolidated returns.[1405] These rules exclude foreign corporations from an affiliated group.[1406] Interest expense allocation rules permitting a U.S. affiliated group to apportion the interest expense of the members of the U.S. affiliated group on a worldwide-group basis were modified in 2004, and initially effective for taxable years beginning after December 31, 2008.[1407] The effective date of the modified rules has been delayed to January 1, 2021.[1408] A result of this rule is that interest expense of foreign members of a U.S. affiliated group is taken into account in determining whether a portion of the interest expense of the domestic members of the group must be allocated to foreign-source income. An allocation to

[1399] IRC sections 901, 902, 960, 1291(g).
[1400] IRC sections 901, 904.
[1401] IRC section 904(c).
[1402] Treasury Regulation section 1.861-8(b), Temporary Treasury Regulation section 1.861-8T(c).
[1403] Temporary Treasury Regulation section 1.861-9T, Treasury Regulation section 1.861-17.
[1404] IRC section 864(e)(1), (6); Temporary Treasury Regulation section 1.861-14T(e)(2).
[1405] IRC sections 864(e)(5), 1504.
[1406] IRC section 1504(b)(3).
[1407] IRC section 864(f); "American Jobs Creation Act of 2004" ("AJCA"), Pub. L. 108-357, section 401(a).
[1408] Hiring Incentives to Restore Employment Act, Public Law Number 111-147, section 551(a).

foreign-source income generally is required only if, in broad terms, the domestic members of the group are more highly leveraged than is the entire worldwide group. The new rules are generally expected to reduce the amount of the U.S. group's interest expense that is allocated to foreign-source income.

The foreign tax credit limitation is applied separately to passive category income and to general category income.[1409] Passive category income includes passive income, such as portfolio interest and dividend income, and certain specified types of income. All other income is in the general category. Passive income is treated as general category income if it is earned by a qualifying financial services entity. Passive income is also treated as general category income if it is highly taxed (that is, if the foreign tax rate is determined to exceed the highest rate of tax specified in IRC section 1 or 11, as applicable). Dividends (and subpart F inclusions), interest, rents, and royalties received by a 10-percent U.S. shareholder from a CFC are assigned to a separate limitation category by reference to the category of income out of which the dividends or other payments were made.[1410] Dividends received by a 10-percent corporate shareholder of a foreign corporation that is not a CFC are also categorized on a look-through basis.[1411]

Special rules apply to the allocation of income and losses from foreign and U.S. sources within each category of income.[1412] Foreign losses from one category will first be used to offset income from foreign sources of other categories. If there remains an overall foreign loss, it will be deducted against income from U.S. sources. The same principle applies to losses from U.S. sources. In subsequent years, the losses that were deducted against another category or source of income will be recaptured. That is, an equal amount of income from the same category or source that generated a loss in the prior year will be recharacterized as income from the other category or source against which the loss was deducted. Up to 50 percent of income from one source in any subsequent year will be recharacterized as income from the other source, whereas foreign-source income in a particular category can be fully recharacterized as income in another category until the losses from prior years are fully recaptured.[1413]

In addition to the foreign tax credit limitation just described, a taxpayer's ability to claim a foreign tax credit may be further limited by a matching rule that prevents the separation of creditable foreign taxes from the associated foreign income. Under this rule, a foreign tax generally is not taken into account for U.S. tax purposes, and thus no foreign tax credit is available with respect to

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[1409] IRC section 904(d). AJCA generally reduced the number of income categories from nine to two, effective for tax years beginning in 2006. Before AJCA, the foreign tax credit limitation was applied separately to the following categories of income: (1) passive income, (2) high withholding tax interest, (3) financial services income, (4) shipping income, (5) certain dividends received from noncontrolled IRC section 902 foreign corporations (also known as "10/50 companies"), (6) certain dividends from a domestic international sales corporation or former domestic international sales corporation, (7) taxable income attributable to certain foreign trade income, (8) certain distributions from a foreign sales corporation or former foreign sales corporation, and (9) any other income not described in items (1) through (8) (so-called "general basket" income). A number of other provisions of the IRC, including several enacted in 2010 as part of Public Law Number 111-226, create additional separate categories in specific circumstances or limit the availability of the foreign tax credit in other ways. See, e.g., IRC sections 865(h), 901(j), 904(d)(6), 904(h)(10).
[1410] IRC section 904(d)(3). The subpart F rules applicable to CFCs and their 10-percent U.S. shareholders are described below.
[1411] IRC section 904(d)(4).
[1412] IRC sections 904(f), (g).
[1413] IRC sections 904(f)(1), (g)(1).

that foreign tax, until the taxable year in which the related income is taken into account for U.S. tax purposes.[1414]

Section	Section Title
14301	Repeal of IRC Section 902 Indirect Foreign Tax Credits; Determination of IRC Section 960 Credit on Current Year Basis

New Federal Law (IRC sections 902 and 960)

The provision repeals the deemed-paid credit with respect to dividends received by a domestic corporation that owns 10 percent or more of the voting stock of a foreign corporation.

A deemed-paid credit is provided with respect to any income inclusion under subpart F. The deemed-paid credit is limited to the amount of foreign income taxes properly attributable to the subpart F inclusion. Foreign income taxes under the proposal include income, war profits, or excess profits taxes paid or accrued by the CFC to any foreign country or possession of the United States. The proposal eliminates the need for computing and tracking cumulative tax pools.

Additionally, the provision provides rules applicable to foreign taxes attributable to distributions from previously taxed earnings and profits, including distributions made through tiered-CFCs.

The Secretary is granted authority under the proposal to provide regulations and other guidance as may be necessary and appropriate to carry out the purposes of this proposal. It is anticipated that the Secretary would provide regulations with rules for allocating taxes similar to rules in place for purposes of determining the allocation of taxes to specific foreign tax credit baskets.[1415] Under such rules, taxes are not attributable to an item of subpart F income if the base upon which the tax was imposed does not include the item of subpart F income. For example, if foreign law exempts a certain type of income from its tax base, no deemed-paid credit results from the inclusion of such income as subpart F. Tax imposed on income that is not included in subpart F income is not considered attributable to subpart F income.

In addition to the rules described in this section, the provision makes several conforming amendments to various other sections of the IRC reflecting the repeal of IRC section 902 and the modification of IRC section 960. These conforming amendments include amending the IRC section 78 gross-up provision to apply solely to taxes deemed paid under the amended IRC section 960.

The provision applies the existing language of IRC section 78, which treats the gross-up as a dividend to the domestic corporation, to foreign income taxes deemed paid under IRC section 960(a), (b), and (d) (without regard to the phrase '80 percent of' in IRC section 960(d)(1), except with respect to IRC section 245 and new IRC section 245A (i.e., the deemed dividend would not receive the benefit of the participation exemption). The provision further revises new IRC section

[1414] IRC section 909.
[1415] See Treasury Regulation section 1.904-6(a).

250(a)(1)(B) to apply the deduction with respect to inclusions under new IRC section 951A to the IRC section 78 gross-up.

In addition, the provision eliminates the dividend reference in IRC section 907(c)(3)(A) without disturbing the application of IRC section 907(c)(3)(A) to certain interest payments. The provision also amends IRC section 1293(f) to provide IRC section 960(a) credits to an inclusion of income of a qualified electing fund (as defined in IRC section 1295) consistent with prior law.

The provision makes certain conforming amendments to IRC sections 901(m), 904, 907, and 909, including replacing the reference to IRC section 960(b) in IRC section 904(k) to IRC section 960(c), striking the reference to IRC section 902 in IRC section 904(d)(2)(E), and preserving the current applicability of IRC sections 901(m) and 909 to all taxpayers who claim foreign tax credits, including qualified electing funds.

<u>Effective Dates</u>

The provision applies to taxable years taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of United States shareholders in which or with which such taxable years of foreign corporations end.

<u>California Law (R&TC section 17024.5, 23051.5, and 25110)</u>

California does not allow a foreign tax credit.

California does not conform to subpart F (sections 951 to 965) of the IRC, relating to controlled foreign corporations, except to the extent applicable with respect to water's-edge elections.

<u>Impact on California Revenue</u>

Not applicable.

Section	Section Title
14302	Separate Foreign Tax Credit Limitation Basket for Foreign Branch Income

New Federal Law (IRC section 904)

The provision requires foreign branch income to be allocated to a specific foreign tax credit basket. Foreign branch income is the business profits of a United States person which are attributable to one or more QBUs in one or more foreign countries.

Under this provision, business profits of a QBU shall be determined under rules established by the Secretary. Business profits of a QBU shall not, however, include any income which is passive category income.

Effective Dates

The provision is effective for taxable years beginning after December 31, 2017.

California Law R&TC section 17024.5 and 23051.5)

California does not allow a foreign tax credit.

Impact on California Revenue

Not applicable.

Section	Section Title
14303	Source of Income from Sales of Inventory Determined Solely On Basis of Production Activities

New Federal Law (IRC section 863(b))

Under the provision, gains, profits, and income from the sale or exchange of inventory property produced partly in, and partly outside, the United States is allocated and apportioned on the basis of the location of production with respect to the property. For example, income derived from the sale of inventory property to a foreign jurisdiction is sourced wholly within the United States if the property was produced entirely in the United States, even if title passage occurred elsewhere. Likewise, income derived from inventory property sold in the United States, but produced entirely in another country, is sourced in that country even if title passage occurs in the United States. If the inventory property is produced partly in, and partly outside, the United States, however, the income derived from its sale is sourced partly in the United States.

Effective Dates

The provision is effective for taxable years beginning after December 31, 2017.

California Law (R&TC sections 17951, 23040.1, and 25110)

Except as provided in R&TC sections 23040.1[1416] and 25110, federal rules for determining the sources of income (IRC sections 861 to 865, including IRC section 863, relating to special rules for determining source) are not applicable for California franchise or income tax purposes.

California exercises its taxing powers based on two jurisdictional concepts: (1) the residency of the individual, and (2) the source of the income. Residents of California pay state taxes on all income received regardless of its geographical source. Nonresidents of California are taxed by California only on income derived from sources within California's boundaries ("source income").

Source income includes wages earned from services performed in California, gains from the disposition of property located in California, and profits from business transacted in California. Intangible income, such as investment interest, is considered to originate in the state in which the recipient resides at the time it is earned, unless it is earned in connection with a trade or business.

[1416] IRC section 864(b)(2)(A)(ii), relating to trading in securities for a taxpayer's own account.

Worldwide Unitary Method

California corporate taxpayers doing business both within and without California are required to compute their California franchise or income tax using the worldwide unitary method. Under this method, a corporate taxpayer's business income from both domestic and foreign unitary operations is considered in the calculation of the taxpayer's tax base, and a share of that business income is then “apportioned” to California using a formula. Income apportioned to California is subject to California franchise or income tax. The formula measures relative levels of business activity in the state by using the amount of the taxpayer’s sales in California divided by the taxpayer's sales everywhere.[1417] This measure of activities is commonly called the “single sales-factor formula.” The amount of sales from both domestic and foreign activities are included in the calculation of the apportionment formula. Generally, dividends paid from one member to another within the unitary group from unitary earnings are eliminated from tax computations under R&TC section 25106.

California Water's-Edge Election

As an alternative to the worldwide unitary method, California law allows corporations to elect to determine the business income of their combined reporting group on a "water's-edge" basis. In general, the water’s-edge method excludes foreign corporations from the calculation of business income. An exception to this general rule is a foreign (non-U.S.) corporation with income that is effectively connected with the conduct of a trade or business within the United States (ECI), and the average of its property, payroll, and sales factors within the United States is less than 20 percent. The income and factors of such foreign corporation are included in a water's-edge combined report to the extent of its ECI and related factors assignable to a location within the U.S.[1418]

R&TC section 25110 provides that federal income tax laws apply to determine that foreign corporation's ECI to be included in a water's-edge combined report.[1419] Regulations adopted under R&TC section 25110 specifically requires the source of the ECI be determined in accordance with the sourcing rules set forth in IRC sections 861 through 865, including IRC section 863.[1420] As a result, the new sourcing rule of inventory property sales is applicable with respect to water's-edge elections for taxable years beginning after December 31, 2017.

[1417] An apportioning trade or business conducting certain qualified business activities is required to use an evenly weighted three-factor formula consisting of property, payroll, and sales to apportion its business income to California. (R&TC section 25128.)
[1418] R&TC section 25110(a)(2)(A)(i).
[1419] R&TC section 25110(a)(2)(A)(i) provides, in pertinent part, "[i]ncome of that corporation derived from or attributable to sources within the United States as determined by federal income tax laws . . . ."
[1420] Cal. Code Regs., tit. 18, §25110(d)(2)(F)1.a.

Impact on California Revenue

Estimated Conformity Revenue Impact of Source of Income from Sales of Inventory Determined Solely On Basis of Production Activities For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	$900,000	$700,000	$600,000

Section	Section Title
14304	Election to Increase Percentage of Domestic Taxable Income Offset by Overall Domestic Loss Treated as Foreign Source

New Federal Law (IRC section 904(g))

The provision modifies IRC section 904(g) by providing an election to increase the percentage (but not greater than 100 percent) of domestic taxable income offset by any pre-2018 unused overall domestic loss and recharacterized as foreign source. The term "pre-2018 unused overall domestic loss" means any overall domestic loss which: (1) arises in a qualified taxable year beginning before January 1, 2018, and (2) has not been used under the general rule set forth in IRC section 904(g)(1). The term "qualified taxable year" means any taxable year of the taxpayer beginning after December 31, 2017, and before January 1, 2028.

Effective Dates

The provision shall apply to taxable years beginning after December 31, 2017, and before January 1, 2028.

California Law R&TC section 17024.5 and 23051.5)

California does not allow a foreign tax credit.

Impact on California Revenue

Not applicable.

Part II—Inbound Transactions

Background

U.S. Tax Rules Applicable to Nonresident Aliens and Foreign Corporations (Inbound)

Nonresident aliens and foreign corporations are generally subject to U.S. tax only on their U.S.-source income. Thus, the source and type of income received by a foreign person generally determines whether there is any U.S. income tax liability and the mechanism by which it is taxed. The U.S. tax rules for U.S. activities of foreign taxpayers apply differently to two broad types of income: U.S.-source income that is "fixed or determinable annual or periodical gains, profits, and income" (FDAP income) or income that is "effectively connected with the conduct of a trade or business within the United States" (ECI). FDAP income generally is subject to a 30-percent gross-basis tax withheld at its source, while ECI is generally subject to the same U.S. tax rules that apply to business income derived by U.S. persons. That is, deductions are permitted in determining taxable ECI, which is then taxed at the same rates applicable to U.S. persons. Much FDAP income and similar income is, however, exempt from tax or is subject to a reduced rate of tax under the IRC[1421] or a bilateral income tax treaty.[1422]

1. Gross-Basis Taxation of U.S.-Source Income.

Non-business income received by foreign persons from U.S. sources is generally subject to tax on a gross basis at a rate of 30 percent, which is collected by withholding at the source of the payment. As explained below, the categories of income subject to the 30-percent tax and the categories for which withholding is required are generally coextensive, with the result that determining the withholding tax liability determines the substantive liability.

The income of non-resident aliens or foreign corporations that is subject to tax at a rate of 30-percent includes FDAP income that is not effectively connected with the conduct of a U.S. trade or business.[1423] The items enumerated in defining FDAP income are illustrative; the common characteristic of types of FDAP income is that taxes with respect to the income may be readily computed and collected at the source, in contrast to the administrative difficulty involved in determining the seller's basis and resulting gain from sales of property.[1424] The words "annual or periodical" are "merely generally descriptive" of the payments that could be within the purview of the statute and do not preclude application of the withholding tax to one-time, lump sum payments to nonresident aliens.[1425]

[1421] *E.g.,* the portfolio interest exception in IRC section 871(h) (discussed below).
[1422] Because each treaty reflects considerations unique to the relationship between the two treaty countries, treaty withholding tax rates on each category of income are not uniform across treaties.
[1423] IRC sections 871(a), 881. If the FDAP income is also ECI, it is taxed on a net basis, at graduated rates.
[1424] *Commissioner v. Wodehouse,* 337 U.S. 369, 388-89 (1949). After reviewing the legislative history of the Revenue Act of 1936, the Supreme Court noted that Congress expressly intended to limit taxes on nonresident aliens to taxes that could be readily collectible, *i.e.,* subject to withholding, in response to "a theoretical system impractical of administration in a great number of cases. H.R. Rep. No. 2475, 74th Cong., 2d Sess. 9-10 (1936)." In doing so, the Court rejected P.G. Wodehouse's arguments that an advance royalty payment was not within the purview of the statutory definition of FDAP income.
[1425] *Commissioner v. Wodehouse*, 337 U.S. 369, 393 (1949).

With respect to income from shipping, the gross basis tax potentially applicable is four percent,[1426] unless the income is effectively connected with a U.S. trade or business, and thus subject to the graduated rates, as determined under rules specific to U.S.-source gross transportation income rather than the more broadly applicable rules defining effectively connected income in IRC section 864(c). Even if the income is within the purview of those special rules, it may nevertheless be exempt if the income is derived from the international operation of a ship or aircraft by a foreign entity organized in a jurisdiction which provides a reciprocal exemption to U.S. entities.[1427]

Types of FDAP Income

FDAP income encompasses a broad range of types of gross income, but has limited application to gains on sales of property, including market discount on bonds and option premiums.[1428] Capital gains received by nonresident aliens present in the United States for fewer than 183 days are generally treated as foreign source and are thus not subject to U.S. tax, unless the gains are effectively connected with a U.S. trade or business; capital gains received by nonresident aliens present in the United States for 183 days or more[1429] that are treated as income from U.S. sources are subject to gross-basis taxation.[1430] In contrast, U.S-source gains from the sale or exchange of intangibles are subject to tax and withholding if they are contingent upon the productivity of the property sold and are not effectively connected with a U.S. trade or business.[1431]

Interest on bank deposits may qualify for exemption on two grounds, depending on where the underlying principal is held on deposit. Interest paid with respect to deposits with domestic banks and savings and loan associations, and certain amounts held by insurance companies, are U.S.-source income but are not subject to the U.S. tax when paid to a foreign person, unless the interest is effectively connected with a U.S. trade or business of the recipient.[1432] Interest on deposits with foreign branches of domestic banks and domestic savings and loan associations is not treated as U.S.-source income and is thus exempt from U.S. tax (regardless of whether the recipient is engaged in a U.S. trade or business).[1433] Similarly, interest and original issue discount on certain short-term obligations is also exempt from U.S. tax when paid to a foreign person.[1434]

[1426] IRC section 887.
[1427] IRC section 883(a)(1). In addition, to the extent provided in regulations, income from shipping and aviation is not subject to the four-percent gross basis tax if the income is of a type that is not subject to the reciprocal exemption for net basis taxation. See IRC section 887(b)(1). Comparable rules under IRC section 872(b)(1) apply to income of nonresident alien individuals from shipping operations.
[1428] Although technically insurance premiums paid to a foreign insurer or reinsurer are FDAP income, they are exempt from withholding under Treasury Regulation section 1.1441-2(a)(7) if the insurance contract is subject to the excise tax under IRC section 4371. Treasury Regulations sections 1.1441-2(b)(1)(i) and 1.1441-2(b)(2).
[1429] For purposes of this rule, whether a person is considered a resident in the United States is determined by application of the rules under IRC section 7701(b).
[1430] IRC section 871(a)(2). In addition, certain capital gains from sales of U.S. real property interests are subject to tax as effectively connected income (or in some instances as dividend income) under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA").
[1431] IRC sections 871(a)(1)(D), 881(a)(4).
[1432] IRC sections 871(i)(2)(A), 881(d); Treasury Regulation section 1.1441-1(b)(4)(ii).
[1433] IRC section 861(a)(1)(B); Treasury Regulation section 1.1441-1(b)(4)(iii).
[1434] IRC sections 871(g)(1)(B), 881(a)(3); Treasury Regulation section 1.1441-1(b)(4)(iv).

Additionally, there is generally no information reporting required with respect to payments of such amounts.[1435]

Although FDAP income includes U.S.-source portfolio interest, such interest is specifically exempt from the 30-percent gross-basis tax. Portfolio interest is any interest (including original issue discount) that is paid on an obligation that is in registered form and for which the beneficial owner has provided to the U.S. withholding agent a statement certifying that the beneficial owner is not a U.S. person.[1436] For obligations issued before March 19, 2012, portfolio interest also includes interest paid on an obligation that is not in registered form, provided that the obligation is shown to be targeted to foreign investors under the conditions sufficient to establish deductibility of the payment of such interest.[1437] Portfolio interest, however, does not include interest received by a 10-percent shareholder,[1438] certain contingent interest,[1439] interest received by a controlled foreign corporation from a related person,[1440] or interest received by a bank on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of its trade or business.[1441]

Imposition of Gross-Basis Tax and Reporting by U.S. Withholding Agents

The 30-percent tax on FDAP income is generally collected by means of withholding.[1442] Withholding on FDAP payments to foreign payees is required unless the withholding agent,[1443] *i.e.,* the person making the payment to the foreign person receiving the income, can establish that the beneficial owner of the amount is eligible for an exemption from withholding or a reduced rate of withholding under an income tax treaty.[1444] The principal statutory exemptions from the 30-percent tax apply to interest on bank deposits, and portfolio interest, described above.[1445]

In many instances, the income subject to withholding is the only income of the foreign recipient that is subject to any U.S. tax. No Federal income tax return from the foreign recipient is generally

[1435] Treasury Regulation section 1.1461-1(c)(2)(ii)(A), (B). Regulations require a bank to report interest if the recipient is a nonresident alien who resides in a country with which the United States has a satisfactory exchange of information program under a bilateral agreement and the deposit is maintained at an office in the United States. Treasury Regulations sections 1.6049-4(b)(5) and 1.6049-8. The IRS publishes lists of the countries whose residents are subject to the reporting requirements, and those countries with respect to which the reported information will be automatically exchanged. Rev. Proc. 2017-31, available at *https://www.irs.gov/pub/irs-drop/rp-17-31.pdf*, supplementing Rev. Proc. 2014-64.
[1436] IRC section 871(h)(2).
[1437] IRC section 163(f)(2)(B). The exception to the registration requirements for foreign targeted securities was repealed in 2010, effective for obligations issued two years after enactment, thus narrowing the portfolio interest exemption for obligations issued after March 18, 2012. See Hiring Incentives to Restore Employment Law of 2010, Public Law Number 111-147, IRC section 502(b).
[1438] IRC section 871(h)(3).
[1439] IRC section 871(h)(4).
[1440] IRC section 881(c)(3)(C).
[1441] IRC section 881(c)(3)(A).
[1442] IRC sections 1441, 1442.
[1443] Withholding agent is defined broadly to include any U.S. or foreign person that has the control, receipt, custody, disposal, or payment of an item of income of a foreign person subject to withholding. Treasury Regulation section 1.1441-7(a).
[1444] IRC sections 871, 881, 1441, 1442; Treasury Regulation section 1.1441-1(b).
[1445] A reduced rate of withholding of 14 percent applies to certain scholarships and fellowships paid to individuals temporarily present in the United States. IRC section 1441(b). In addition to statutory exemptions, the 30-percent tax with respect to interest, dividends and royalties may be reduced or eliminated by a tax treaty between the United States and the country in which the recipient of income otherwise subject to tax is resident.

required with respect to the income from which tax was withheld, if the recipient has no ECI income and the withholding is sufficient to satisfy the recipient's liability. Accordingly, although the 30-percent gross-basis tax is a withholding tax, it is also generally the final tax liability of the foreign recipient (unless the foreign recipient files for a refund).

A withholding agent that makes payments of U.S.-source amounts to a foreign person is required to report and pay over any amounts of U.S. tax withheld. The reports are due to be filed with the IRS by March 15 of the calendar year following the year in which the payment is made. Two types of reports are required: (1) a summary of the total U.S.-source income paid and withholding tax withheld on foreign persons for the year and (2) a report to both the IRS and the foreign person of that person's U.S.-source income that is subject to reporting.[1446] The nonresident withholding rules apply broadly to any financial institution or other payor, including foreign financial institutions.[1447]

To the extent that the withholding agent deducts and withholds an amount, the withheld tax is credited to the recipient of the income.[1448] If the agent withholds more than is required, and results in an overpayment of tax, the excess may be refunded to the recipient of the income upon filing of a timely claim for refund.

Excise Tax on Foreign Reinsurance Premiums

An excise tax applies to premiums paid to foreign insurers and reinsurers covering U.S. risks.[1449] The excise tax is imposed on a gross basis at the rate of one percent on reinsurance and life insurance premiums, and at the rate of four percent on property and casualty insurance premiums. The excise tax does not apply to premiums that are effectively connected with the conduct of a U.S. trade or business or that are exempted from the excise tax under an applicable income tax treaty. The excise tax paid by one party cannot be credited if, for example, the risk is reinsured with a second party in a transaction that is also subject to the excise tax.

Many U.S. tax treaties provide an exemption from the excise tax, including the treaties with Germany, Japan, Switzerland, and the United Kingdom.[1450] To prevent persons from inappropriately obtaining the benefits of exemption from the excise tax, the treaties generally include an anti-conduit rule. The most common anti-conduit rule provides that the treaty exemption applies to the excise tax only to the extent that the risks covered by the premiums are not reinsured with a person not entitled to the benefits of the treaty (or any other treaty that provides exemption from the excise tax).[1451]

[1446] Treasury Regulation section 1.1461-1(b), (c).
[1447] See Treasury Regulation section 1.1441-7(a) (definition of withholding agent includes foreign persons).
[1448] IRC section 1462.
[1449] IRC sections 4371-4374.
[1450] Generally, when a foreign person qualifies for benefits under such a treaty, the United States is not permitted to collect the insurance premiums excise tax from that person.
[1451] In Rev. Rul. 2008-15, 2008-1 C.B. 633, the IRS provided guidance to the effect that the excise tax is imposed separately on each reinsurance policy covering a U.S. risk. Thus, if a U.S. insurer or reinsurer reinsures a U.S. risk with a foreign reinsurer, and that foreign reinsurer in turn reinsures the risk with a second foreign reinsurer, the excise tax applies to both the premium to the first foreign reinsurer and the premium to the second foreign reinsurer. In addition, if the first foreign reinsurer is resident in a jurisdiction with a tax treaty containing an excise tax exemption, the revenue ruling provides that the excise tax still applies to both payments to the extent that the transaction violates

2. Net-Basis Taxation of U.S.-Source Income

The United States taxes on a net basis the income of foreign persons that is "effectively connected" with the conduct of a trade or business in the United States.[1452] Any gross income derived by the foreign person that is not effectively connected with the person's U.S. business is not taken into account in determining the rates of U.S. tax applicable to the person's income from the business.[1453]

U.S. Trade or Business

A foreign person is subject to U.S. tax on a net basis if the person is engaged in a U.S. trade or business. Partners in a partnership and beneficiaries of an estate or trust are treated as engaged in the conduct of a trade or business within the United States if the partnership, estate, or trust is so engaged.[1454]

The question whether a foreign person is engaged in a U.S. trade or business is factual and has generated much case law. Basic issues include whether the activity constitutes business rather than investing, whether sufficient activities in connection with the business are conducted in the United States, and whether the relationship between the foreign person and persons performing functions in the United States in respect of the business is sufficient to attribute those functions to the foreign person.

The trade or business rules differ from one activity to another. The term "trade or business within the United States" expressly includes the performance of personal services within the United States.[1455] If, however, a nonresident alien individual performs personal services for a foreign employer, and the individual's total compensation for the services and period in the United States are minimal ($3,000 or less in total compensation and 90 days or fewer of physical presence in a year), the individual is not considered to be engaged in a U.S. trade or business.[1456] Detailed rules govern whether trading in stocks or securities or commodities constitutes the conduct of a U.S. trade or business.[1457] A foreign person who trades in stock or securities or commodities in the United States through an independent agent generally is not treated as engaged in a U.S. trade or business if the foreign person does not have an office or other fixed place of business in the United States through which trades are carried out. A foreign person who trades stock or securities or commodities for the person's own account also generally is not considered to be engaged in a U.S. business so long as the foreign person is not a dealer in stock or securities or commodities.

an anti-conduit rule in the applicable tax treaty. Even if no violation of an anti-conduit rule occurs, under the revenue ruling, the excise tax still applies to the premiums paid to the second foreign reinsurer, unless the second foreign reinsurer is itself entitled to an excise tax exemption.

[1452] IRC sections 871(b), 882.
[1453] IRC sections 871(b)(2), 882(a)(2).
[1454] IRC section 875.
[1455] IRC section 864(b).
[1456] IRC section 864(b)(1).
[1457] IRC section 864(b)(2).

For eligible foreign persons, U.S. bilateral income tax treaties restrict the application of net-basis U.S. taxation. Under each treaty, the United States is permitted to tax business profits only to the extent those profits are attributable to a U.S. permanent establishment of the foreign person. The threshold level of activities that constitute a permanent establishment is generally higher than the threshold level of activities that constitute a U.S. trade or business. For example, a permanent establishment typically requires the maintenance of a fixed place of business over a significant period of time.

Effectively Connected Income

A foreign person that is engaged in the conduct of a trade or business within the United States is subject to U.S. net-basis taxation on the income that is "effectively connected" with the business. Specific statutory rules govern whether income is ECI.[1458]

In the case of U.S.-source capital gain and U.S.-source income of a type that would be subject to gross basis U.S. taxation, the factors taken into account in determining whether the income is ECI include whether the income is derived from assets used in or held for use in the conduct of the U.S. trade or business and whether the activities of the trade or business were a material factor in the realization of the amount (the "asset use" and "business activities" tests).[1459] Under the asset use and business activities tests, due regard is given to whether the income, gain, or asset was accounted for through the U.S. trade or business. All other U.S.-source income is treated as ECI.[1460]

A foreign person who is engaged in a U.S. trade or business may have limited categories of foreign-source income that are considered to be ECI.[1461] Foreign-source income not included in one of these categories (described next) generally is exempt from U.S. tax.

A foreign person's income from foreign sources generally is considered to be ECI only if the person has an office or other fixed place of business within the United States to which the income is attributable and the income is in one of the following categories: (1) rents or royalties for the use of patents, copyrights, secret processes or formulas, good will, trademarks, trade brands, franchises, or other like intangible properties derived in the active conduct of the trade or business; (2) interest or dividends derived in the active conduct of a banking, financing, or similar business within the United States or received by a corporation the principal business of which is trading in stocks or securities for its own account; or (3) income derived from the sale or exchange (outside the United States), through the U.S. office or fixed place of business, of inventory or property held by the foreign person primarily for sale to customers in the ordinary course of the trade or business, unless the sale or exchange is for use, consumption, or disposition outside the United States and an office or other fixed place of business of the foreign person in a foreign country participated materially in the sale or exchange.[1462] Foreign-source dividends, interest,

[1458] IRC section 864(c).
[1459] IRC section 864(c)(2).
[1460] IRC section 864(c)(3).
[1461] This income is subject to net-basis U.S. taxation after allowance of a credit for any foreign income tax imposed on the income. IRC section 906.
[1462] IRC section 864(c)(4)(B).

and royalties are not treated as ECI if the items are paid by a foreign corporation more than 50 percent (by vote) of which is owned directly, indirectly, or constructively by the recipient of the income.[1463]

In determining whether a foreign person has a U.S. office or other fixed place of business, the office or other fixed place of business of an agent generally is disregarded. The place of business of an agent other than an independent agent acting in the ordinary course of business is not disregarded, however, if the agent either has the authority (regularly exercised) to negotiate and conclude contracts in the name of the foreign person or has a stock of merchandise from which he regularly fills orders on behalf of the foreign person.[1464] If a foreign person has a U.S. office or fixed place of business, income, gain, deduction, or loss is not considered attributable to the office unless the office was a material factor in the production of the income, gain, deduction, or loss and the office regularly carries on activities of the type from which the income, gain, deduction, or loss was derived.[1465]

Special rules apply in determining the ECI of an insurance company. The foreign-source income of a foreign corporation that is subject to tax under the insurance company provisions of the Code is treated as ECI if the income is attributable to its United States business.[1466]

Income, gain, deduction, or loss for a particular year generally is not treated as ECI if the foreign person is not engaged in a U.S. trade or business in that year.[1467] If, however, income or gain taken into account for a taxable year is attributable to the sale or exchange of property, the performance of services, or any other transaction that occurred in a prior taxable year, the determination whether the income or gain is taxable on a net basis is made as if the income were taken into account in the earlier year and without regard to the requirement that the taxpayer be engaged in a trade or business within the United States during the later taxable year.[1468] If any property ceases to be used or held for use in connection with the conduct of a U.S. trade or business and the property is disposed of within 10 years after the cessation, the determination whether any income or gain attributable to the disposition of the property is taxable on a net basis is made as if the disposition occurred immediately before the property ceased to be used or held for use in connection with the conduct of a U.S. trade or business and without regard to the requirement that the taxpayer be engaged in a U.S. business during the taxable year for which the income or gain is taken into account.[1469]

Transportation income from U.S. sources is treated as effectively connected with a foreign person's conduct of a U.S. trade or business only if the foreign person has a fixed place of business in the United States that is involved in the earning of such income and substantially all of such income of the foreign person is attributable to regularly scheduled transportation.[1470] If the transportation income is effectively connected with conduct of a U.S. trade or business, the

[1463] IRC section 864(c)(4)(D)(i).
[1464] IRC section 864(c)(5)(A).
[1465] IRC section 864(c)(5)(B).
[1466] IRC section 864(c)(4)(C).
[1467] IRC section 864(c)(1)(B).
[1468] IRC section 864(c)(6).
[1469] IRC section 864(c)(7).
[1470] IRC section 887(b)(4).

transportation income, along with transportation income that is from U.S. sources because the transportation both begins and ends in the United States, may be subject to net-basis taxation. Income from the international operation of a ship or aircraft may be eligible for an exemption under IRC section 883, provided that the foreign jurisdiction has extended reciprocity for U.S. businesses;[1471] whether the party claiming an exemption is eligible for the tax relief;[1472] and the activities that give rise to the income qualify under relevant regulations.

Allowance of Deductions

Taxable ECI is computed by taking into account deductions associated with gross ECI. For this purpose, the apportionment and allocation of deductions is addressed in detailed regulations. The regulations applicable to deductions other than interest expense set forth general guidelines for allocating deductions among classes of income and apportioning deductions between ECI and non-ECI. In some circumstances, deductions may be allocated on the basis of units sold, gross sales or receipts, costs of goods sold, profits contributed, expenses incurred, assets used, salaries paid, space used, time spent, or gross income received. More specific guidelines are provided for the allocation and apportionment of research and experimental expenditures, legal and accounting fees, income taxes, losses on dispositions of property, and net operating losses. Detailed regulations under IRC section 861 address the allocation and apportionment of interest deductions. In general, interest is allocated and apportioned based on assets rather than income.

a. Special rules

FIRPTA[1473]

A foreign person's gain or loss from the disposition of a U.S. real property interest (USRPI) is treated as ECI and, therefore, is taxable at the income tax rates applicable to U.S. persons, including the rates for net capital gain. A foreign person subject to tax on this income is required to file a U.S. tax return under the normal rules relating to receipt of ECI.[1474] In the case of a foreign corporation, the gain from the disposition of a USRPI may also be subject to the branch profits tax at a 30-percent rate (or lower treaty rate).

The payor of income that FIRPTA treats as ECI (FIRPTA income) is generally required to withhold U.S. tax from the payment.[1475] The foreign person can request a refund with its U.S. tax return, if appropriate, based on that person's total ECI and deductions (if any) for the taxable year.

[1471] The most recent compilation of countries that the United States recognizes as providing exemptions lists countries in three groups: Twenty-seven countries are eligible for exemption on the basis of a review of the legislation in the foreign jurisdiction; 39 nations exchanged diplomatic notes with the United States that grant exemption to some extent; and more than 50 nations are parties with the United States to bilateral income tax treaties that include a shipping article. Rev. Rul. 2008-17, 2008-1 C.B. 626, modified by Ann. 2008-57, 2008-C.B. 1192, 2008.
[1472] IRC section 883(c) and regulations thereunder.
[1473] Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) enacted IRC section 897.
[1474] IRC section 897(a).
[1475] IRC section 1445 and Treasury regulations thereunder.

Branch Profits Taxes

A domestic corporation owned by foreign persons is subject to U.S. income tax on its net income. The earnings of the domestic corporation are subject to a second tax, this time at the shareholder level, when dividends are paid. As described previously, when the shareholders are foreign, the second-level tax is imposed at a flat rate and collected by withholding. Unless the portfolio interest exemption or another exemption applies, interest payments made by a domestic corporation to foreign creditors are likewise subject to U.S. tax. To approximate these second-level withholding taxes imposed on payments made by domestic subsidiaries to their foreign parent corporations, the United States taxes a foreign corporation that is engaged in a U.S. trade or business through a U.S. branch on amounts of U.S. earnings and profits that are shifted out of, or amounts of interest that are deducted by, the U.S. branch of the foreign corporation. These branch taxes may be reduced or eliminated under an applicable income tax treaty.[1476]

Under the branch profits tax, the United States imposes a tax of 30 percent on a foreign corporation's ‘‘dividend equivalent amount."[1477] The dividend equivalent amount generally is the earnings and profits of a U.S. branch of a foreign corporation attributable to its ECI.[1478] Limited categories of earnings and profits attributable to a foreign corporation's ECI are excluded in calculating the dividend equivalent amount.[1479]

In arriving at the dividend equivalent amount, a branch's effectively connected earnings and profits are adjusted to reflect changes in a branch's U.S. net equity (that is, the excess of the branch's assets over its liabilities, taking into account only amounts treated as connected with its U.S. trade or business).[1480] The first adjustment reduces the dividend equivalent amount to the extent the branch's earnings are reinvested in trade or business assets in the United States (or reduce U.S. trade or business liabilities). The second adjustment increases the dividend equivalent amount to the extent prior reinvested earnings are considered remitted to the home office of the foreign corporation.

Interest paid by a U.S. trade or business of a foreign corporation generally is treated as if paid by a domestic corporation and therefore is subject to U.S. 30-percent withholding tax (if the interest is paid to a foreign person and a Code or treaty exemption or reduction would not be available if the interest were actually paid by a domestic corporation).[1481] Certain ‘‘excess interest" of a U.S. trade or business of a foreign corporation is treated as if paid by a U.S. corporation to a foreign parent and, therefore, is subject to U.S. 30-percent withholding tax.[1482] For this purpose, excess interest is the excess of the interest expense of the foreign corporation apportioned to the U.S. trade or business over the amount of interest paid by the trade or business.

[1476] See Treasury Regulation sections 1.884-1(g), 1.884-5.
[1477] IRC section 884(a).
[1478] IRC section 884(b).
[1479] See IRC section 884(d)(2) (excluding, for example, earnings and profits attributable to gain from the sale of domestic corporation stock that constitutes a U.S. real property interest described in IRC section 897.
[1480] IRC section 884(b).
[1481] IRC section 884(f)(1)(A).
[1482] IRC section 884(f)(1)(B).

Earnings Stripping

Taxpayers are limited in their ability to reduce the U.S. tax on the income derived from their U.S. operations through certain earnings stripping transactions that involve interest payments. If the payor's debt-to-equity ratio exceeds 1.5 to 1 (a debt-to-equity ratio of 1.5 to 1 or less is considered a "safe harbor"), a deduction for disqualified interest paid or accrued by the payor in a taxable year is generally disallowed to the extent of the payor's excess interest expense.[1483] Disqualified interest includes interest paid or accrued to related parties when no Federal income tax is imposed with respect to such interest;[1484] to unrelated parties in certain instances in which a related party guarantees the debt (guaranteed debt); or to a REIT by a taxable REIT subsidiary of that REIT. Excess interest expense is the amount by which the payor's net interest expense (that is, the excess of interest paid or accrued over interest income) exceeds 50 percent of its adjusted taxable income (generally taxable income computed without regard to deductions for net interest expense, net operating losses, domestic production activities under IRC section 199, depreciation, amortization, and depletion). Interest amounts disallowed under these rules can be carried forward indefinitely and are allowed as a deduction to the extent of any excess limitation in a subsequent tax year. In addition, any excess limitation (that is, the excess, if any, of 50 percent of the adjusted taxable income of the payor over the payor's net interest expense) can be carried forward three years.

<u>Section</u>	<u>Section Title</u>
14401	Base Erosion and Anti-Abuse Tax

<u>New Federal Law (IRC section 6038A and new IRC section 59A)</u>

In General

Under the provision, an applicable taxpayer is required to pay a tax equal to the base erosion minimum tax amount for the taxable year. The base erosion minimum tax amount is the excess of 10 percent[1485] of the modified taxable income of the taxpayer for the taxable year over an amount equal to the regular tax liability (defined in IRC section 26(b)) of the taxpayer for the taxable year reduced (but not below zero) by the excess (if any) of the credits allowed under Chapter 1 against such regular tax liability over the sum of: (1) the credit allowed under IRC section 38 for the taxable year which is properly allocable to the research credit determined under IRC section 41(a), plus (2) the portion of the applicable IRC section 38 credits not in excess of 80 percent of the lesser of the amount of such credits or the base erosion minimum tax amount (determined without regard to this clause (2)). For taxable years beginning after December 31, 2025, two changes are made: (A) the 10-percent provided for above is changed to 12.5-percent, and (B) the

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[1483] IRC section 163(j).
[1484] If a tax treaty reduces the rate of tax on interest paid or accrued by the taxpayer, the interest is treated as interest on which no Federal income tax is imposed to the extent of the same proportion of such interest as the rate of tax imposed without regard to the treaty, reduced by the rate of tax imposed under the treaty, bears to the rate of tax imposed without regard to the treaty. IRC section 163(j)(5)(B).
[1485] 5 percent rate applies for one year for base erosion payments paid or accrued in taxable years beginning after December 31, 2017.

regular tax liability is reduced by the aggregate amount of the credits allowed under Chapter 1 (and no other adjustment is made).[1486]

Applicable IRC section 38 credits means the credit allowed under IRC section 38 for the taxable year which is properly allocable to: (A) the low-income housing credit determined under IRC section 42(a), (B) the renewable electricity production credit determined under IRC section 45(a), and (C) the investment credit determined under IRC section 46, but only to the extent properly allocable to the energy credit determined under IRC section 48.

To determine its modified taxable income, the applicable taxpayer computes its taxable income for the year without regard to any base erosion tax benefit with respect to any base erosion payment or the base erosion percentage of any allowable net operating loss deduction allowed under IRC section 172 for the taxable year.

Base Erosion Payments

A base erosion payment means any amount paid or accrued by a taxpayer to a foreign person that is a related party of the taxpayer and with respect to which a deduction is allowable under Chapter 1. Such payments include any amount paid or accrued by the taxpayer to the related party in connection with the acquisition by the taxpayer from the related party of property of a character subject to the allowance of depreciation (or amortization in lieu of depreciation). A base erosion payment includes any premium or other consideration paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer for any reinsurance payments taken into account under IRC sections 803(a)(1)(B) or 832(b)(4)(A).

Base erosion payments do not include any amount that constitutes reductions in gross receipts, including payments for costs of goods sold. However, a base erosion payment includes any amount that constitutes reductions in gross receipts of the taxpayer that is paid or accrued by the taxpayer with respect to: (1) a surrogate foreign corporation which is a related party of the taxpayer, but only if such person first became a surrogate foreign corporation after November 9, 2017, or (2) a foreign person that is a member of the same expanded affiliated group as the surrogate foreign corporation. A surrogate foreign corporation has the meaning given in IRC section 7874(a)(2), but does not include a foreign corporation treated as a domestic corporation under IRC section 7874(b).

A base erosion payment does not include any amount paid or accrued by a taxpayer for services if such services meet the requirements for eligibility for use of the services cost method described in Treasury Regulation section 1.482-9, as in effect as of the date of enactment of TCJA, without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure and only if the payments are made for services that have no markup component.

[1486] In the case of a taxpayer that is a member of an affiliated group (defined in IRC section 1504(a)(1)) that includes a bank as defined in IRC section 581 or a registered securities dealer defined in IRC section 15(a) of the Securities Exchange Act of 1934, the rates are 6 percent instead of 5 percent, 11 percent instead of 10 percent and 13.5 percent instead of 12.5 percent.

Any qualified derivative payment is not treated as a base erosion payment. A qualified derivative payment means any payment made by a taxpayer pursuant to a derivative with respect to which the taxpayer: (i) recognizes gain or loss as if such derivative were sold for its fair market value on the last business day of the taxable year (and such additional times as are required by this title or the taxpayer's method of accounting), (ii) treats any gain or loss so recognized as ordinary, and (iii) treats the character of all items of income, deduction, gain or loss with respect to a payment pursuant to the derivative as ordinary.

No payment is treated as a qualified derivative payment unless the taxpayer includes in the information required to be reported under IRC section 6038B(b)(2) with respect to such taxable year such information as is necessary to identify the payments to be so treated and such other information as the Secretary of the Treasury determines necessary to carry out the provision. The rule for qualified derivative payments does not apply if a payment with respect to a derivative is in substance, or is disguising, the kind of payment that would be treated as a base erosion payment if it were not made pursuant to a derivative, including any interest, royalty, or service payment, (or any other payment subject to this provision) or in the case of a contract which has derivative and nonderivative components, the payment is properly allocable to the nonderivative component.

For these purposes, the term derivative means any contract (including any option, forward contract, futures contract, short position, swap, or similar contract) the value of which, or any payment or other transfer with respect to which, is (directly or indirectly) determined by reference to one or more of the following: (i) any share of stock of a corporation, (ii) any evidence of indebtedness, (iii) any commodity which is actively traded, (iv) any currency, or (v) any rate, price, amount, index, formula, or algorithm. Except as otherwise provided by the Secretary of the Treasury, American depository receipts and similar instruments with respect to shares of stock in foreign corporations are treated as shares of stock in such foreign corporations. The term derivative does not include any item described in paragraphs (i) through (v) above nor shall the term ‘derivative' include any insurance, annuity, or endowment contract issued by an insurance company to which subchapter L applies (or issued by any foreign corporation to which such subchapter would apply if such foreign corporation were a domestic corporation).

A base erosion tax benefit means: (i) any deduction allowed under Chapter 1 for the taxable year with respect to a base erosion payment, (ii) in the case of a base erosion payment with respect to the purchase of property of a character subject to the allowance for depreciation (or amortization in lieu of depreciation), any deduction allowed in Chapter 1 for depreciation or amortization in lieu of depreciation with respect to the property acquired with such payment, or (iii) any reduction in gross receipts with respect to a payment described above with respect to a surrogate foreign corporation (as defined there) in computing gross income of the taxpayer for the taxable year.

Any base erosion tax benefit attributable to any base erosion payment on which tax is imposed by IRC sections 871 or 881 and with respect to which tax has been deducted and withheld under IRC sections 1441 or 1442, is not taken into account in computing modified taxable income as defined above. The amount not taken into account in computing modified taxable income is reduced under rules similar to the rules under IRC section 163(j)(5)(B).[1487]

The base erosion percentage means, for any taxable year, the percentage determined by dividing the aggregate amount of base erosion tax benefits of the taxpayer for the taxable year by the aggregate amount of the deductions allowable to the taxpayer under Chapter 1 for the taxable year, taking into account base erosion tax benefits described above and by not taking into account any deduction allowed under IRC sections 172, 245A or 250 for the taxable year, any deduction for amounts paid or accrued for services to which the exception for the services cost method (as described above) applies, and any deduction for qualified derivative payments which are not treated as a base erosion payment as described above.

Applicable Taxpayers and Related Parties

Applicable taxpayer means, with respect to any taxable year, a taxpayer: (A) which is a corporation other than a regulated investment company, a real estate investment trust, or an S corporation; (B) the average annual gross receipts of the corporation for the three-taxable-year period ending with the preceding taxable year are at least $500 million, and (C) the base erosion percentage (as defined above) of the corporation for the taxable year is three percent or higher.[1488]

In the case of a foreign person the gross receipts of which are taken into account for purposes of this provision, only gross receipts which are taken into account in determining income effectively connected with the conduct of a trade or business within the United States is taken into account. If a foreign person's gross receipts are aggregated with a U.S. person's gross receipts for reasons described in the aggregation rules below, the preceding sentence does not apply to the gross receipts of any U.S. person which are aggregated with the taxpayer's gross receipts.

All persons treated as a single employer under IRC section 52(a) are treated as one person for purposes of this provision, except that in applying IRC section 1563 for purposes of IRC section 52, the exception for foreign corporations under IRC section 1563(b)(2)(C) is disregarded (called the “aggregation rules”).

For purposes of this provision, foreign person has the meaning given in IRC section 6038A(c)(3).

Related party means: (i) any 25-percent owner of the taxpayer, (ii) any person who is related to the taxpayer or any 25-percent owner of the taxpayer, within the meaning of IRC sections 267(b) or 707(b)(1), and (iii) any other person related to the taxpayer within the meaning of IRC section 482. For these purposes, IRC section 318 regarding constructive ownership of stock applies to these related party rules except that 10-percent is substituted for 50-percent in IRC section 318(a)(2)(C), and for these purposes IRC section 318(a)(3)(A), (B) and (C) do not cause a United States person to own stock owned by a person who is not a United States person.

[1487] As in effect before the date of enactment of TCJA.

[1488] In the case of an applicable taxpayer that is a member of an affiliated group (defined in IRC section 1504(a)(1)) that includes a bank as defined in IRC section 581 or a registered securities dealer defined in section 15(a) of the Securities Exchange Act of 1934, the base erosion percentage of which is two percent or higher.

The provision provides that the Secretary of the Treasury is to prescribe such regulations or other guidance necessary or appropriate, including regulations providing for such adjustments to the application of this section necessary to prevent avoidance of the provision, including through: (1) the use of unrelated persons, conduit transactions, or other intermediaries, or (2) transactions or arrangements designed in whole or in part: (A) to characterize payments otherwise subject to this provision as payments not subject to this provision, or (B) to substitute payments not subject to this provision for payments otherwise subject to this provision.

Information Reporting Requirements[1489]

The provision authorizes the Secretary of the Treasury to prescribe additional reporting requirements under IRC section 6038A relating to: (A) the name, principal place of business, and country or countries in which organized or resident of each person which: (i) is a related party to the reporting corporation, and (ii) had any transaction with the reporting corporation during its taxable year, (B) the manner of relation between the reporting corporation and the person referred to in (A), and (C) transactions between the reporting corporation and each related foreign person.

In addition, for purposes of information reporting under IRC sections 6038A and 6038C, if the reporting corporation or the foreign corporation to which IRC section 6038C applies is an applicable taxpayer under this provision, the information that may be required includes: (A) base erosion payments paid or accrued during the taxable year by the taxpayer to a foreign person which is a related party of the taxpayer, (B) such information as the Secretary of the Treasury finds necessary to determine the base erosion minimum amount of the taxpayer for the taxable year, and (C) such other information as the Secretary of the Treasury determines is necessary.
The penalties provided for under IRC sections 6038A(D)(1) and (2) are both increased to $25,000.

Effective Dates

The provision applies to base erosion payments paid or accrued in taxable years beginning after December 31, 2017.

California Law (R&TC section 18631)

The report required by IRC section 6038A, relating to information with respect to certain foreign-owned corporations, is not required for California purposes. California law provides, under the Administration of Franchise and Income Tax Law (AFITL), that the FTB may require a copy of any information return required to be filed with the Secretary of the Treasury under IRC section

[1489] Section 13306 of the bill (and new IRC section 6050X) establishes certain reporting requirements. These reporting requirements are effective for taxable years beginning after December 31, 2024, and continue to be required regardless of whether the revenue requirement is met. Any taxpayer who makes a payment to a foreign person who is a related party (as such term is defined in section 14401 of the TCJA and new IRC section 59A) of the taxpayer during the taxable year is required to make a return, according to forms and regulations prescribed by the Secretary, setting forth (1) the amount of such payments by type and separately stated and (2) any amount paid that results in a reduction of gross receipts to the taxpayer (*e.g.*, cost of goods sold).

6050X, relating to suits or agreements with respect to violation of any applicable law, at the time and in the form and manner as the FTB may, by forms and instructions, require.

California does not have a tax comparable to the tax imposed under IRC section 59A, relating to tax on base erosion payments of taxpayers with substantial gross receipts.

Impact on California Revenue

Not applicable.

Part III—Other Provisions

Section	Section Title
14501	Restriction on Insurance Business Exception to Passive Foreign Investment Company Rules

Background

Passive foreign investment companies

The Tax Reform Act of 1986[1490] established the PFIC anti-deferral regime. A PFIC is generally defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consists of assets that produce, or are held for the production of, passive income.[1491] Alternative sets of income inclusion rules apply to U.S. persons that are shareholders in a PFIC, regardless of their percentage ownership in the company. One set of rules applies to PFICs that are qualified electing funds, under which electing U.S. shareholders currently include in gross income their respective shares of the company's earnings, with a separate election to defer payment of tax, subject to an interest charge, on income not currently received.[1492] A second set of rules applies to PFICs that are not qualified electing funds, under which U.S. shareholders pay tax on certain income or gain realized through the company, plus an interest charge that is attributable to the value of deferral.[1493] A third set of rules applies to PFIC stock that is marketable, under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as "marking to market."[1494]

[1490] P.L. No. 99-514.
[1491] IRC section 1297.
[1492] IRC sections 1293-1295.
[1493] IRC section 1291.
[1494] IRC section 1296

Under the PFIC regime, passive income is any income which is of a kind that would be foreign personal holding company income, including dividends, interest, royalties, rents, and certain gains on the sale or exchange of property, commodities, or foreign currency. However, among other exceptions, passive income does not include any income derived in the active conduct of an insurance business by a corporation that is predominantly engaged in an insurance business and that would be subject to tax under subchapter L if it were a domestic corporation.[1495] In applying the insurance exception, the IRS analyzes whether risks assumed under contracts issued by a foreign company organized as an insurer are truly insurance risks, whether the risks are limited under the terms of the contracts, and the status of the company as an insurance company.[1496]

<u>New Federal Law (IRC section 1297)</u>

The provision modifies the requirements for a corporation the income of which is not included in passive income for purposes of the PFIC rules. The provision replaces the test based on whether a corporation is predominantly engaged in an insurance business with a test based on the corporation's insurance liabilities.[1497] The requirement that the foreign corporation would be subject to tax under subchapter L if it were a domestic corporation is retained.

Under the provision, passive income for purposes of the PFIC rules does not include income derived in the active conduct of an insurance business by a corporation (1) that would be subject to tax under subchapter L if it were a domestic corporation; and (2) the applicable insurance liabilities of which constitute more than 25 percent of its total assets as reported on the company's applicable financial statement for the last year ending with or within the taxable year.

For the purpose of the provision's exception from passive income, applicable insurance liabilities mean, with respect to any property and casualty or life insurance business: (1) loss and loss adjustment expenses, and (2) reserves (other than deficiency, contingency, or unearned premium reserves) for life and health insurance risks and life and health insurance claims with respect to contracts providing coverage for mortality or morbidity risks. This includes loss reserves for property and casualty, life, and health insurance contracts and annuity contracts. Unearned premium reserves with respect to any type of risk are not treated as applicable insurance

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[1495] IRC section 1297(b)(2)(B).
[1496] Notice 2003-34, 2003-C.B. 1 990, June 9, 2003. See also, Proposed Treasury Regulation section 1.12974, 26 CFR Part 1, REG-108214-15, April 24, 2015.
[1497] Treasury regulations proposed in 2015 have taken a different approach that is based on the current statutory rule. Proposed Treasury Regulation section 1.1297-4, 26 CFR Part 1, REG-108214-15, April 24, 2015. The proposed regulations provide that "the term insurance business means the business of issuing insurance and annuity contracts and the reinsuring of risks underwritten by insurance companies, together with those investment activities and administrative services that are required to support or are substantially related to insurance and annuity contracts issued or reinsured by the foreign corporation." The proposed regulations provide that an investment activity is an activity producing foreign personal holding company income, and that is "required to support or [is] substantially related to insurance and annuity contracts issued or reinsured by the foreign corporation to the extent that income from the activities is earned from assets held by the foreign corporation to meet obligations under the contracts." The preamble to the proposed regulations specifically requests comments on the proposed regulations "with regard to how to determine the portion of a foreign insurance company's assets that are held to meet obligations under insurance contracts issued or reinsured by the company," for example, if the assets "do not exceed a specified percentage of the corporation's total insurance liabilities for the year." *Ibid*.

liabilities for purposes of the provision. For purposes of the provision, the amount of any applicable insurance liability may not exceed the lesser of such amount (1) as reported to the applicable insurance regulatory body in the applicable financial statement (or, if less, the amount required by applicable law or regulation), or (2) as determined under regulations prescribed by the Secretary.

An applicable financial statement is a statement for financial reporting purposes that (1) is made on the basis of generally accepted accounting principles, (2) is made on the basis of international financial reporting standards, but only if there is no statement made on the basis of generally accepted accounting principles, or (3) except as otherwise provided by the Secretary in regulations, is the annual statement required to be filed with the applicable insurance regulatory body, but only if there is no statement made on either of the foregoing bases. Unless otherwise provided in regulations, it is intended that generally accepted accounting principles means U.S. GAAP.

The applicable insurance regulatory body means, with respect to any insurance business, the entity established by law to license, authorize, or regulate such insurance business and to which the applicable financial statement is provided. For example, in the United States, the applicable insurance regulatory body is the State insurance regulator to which the corporation provides its annual statement.

If a corporation fails to qualify solely because its applicable insurance liabilities constitute 25 percent or less of its total assets, a United States person who owns stock of the corporation may elect in such manner as the Secretary prescribes to treat the stock as stock of a qualifying insurance corporation if (1) the corporation's applicable insurance liabilities constitute at least 10 percent of its total assets, and (2) based on the applicable facts and circumstances, the corporation is predominantly engaged in an insurance business, and its failure to qualify under the 25 percent threshold is due solely to runoff-related or rating-related circumstances involving such insurance business.

Facts and circumstances that tend to show the firm may not be predominantly engaged in an insurance business include a small number of insured risks with low likelihood but large potential costs; workers focused to a greater degree on investment activities than underwriting activities; and low loss exposure. Additional relevant facts for determining whether the firm is predominantly engaged in an insurance business include: claims payment patterns for the current and prior years; the firm's loss exposure as calculated for a regulator such as the SEC or for a rating agency, or if those are not calculated, for internal pricing purposes; the percentage of gross receipts constituting premiums for the current and prior years; and the number and size of insurance contracts issued or taken on through reinsurance by the firm. The fact that a firm has been holding itself out as an insurer for a long period is not determinative either way.

Runoff-related or rating-related circumstances include, for example, the fact that the company is in runoff, that is, it is not taking on new insurance business (and consequently has little or no premium income), and is using its remaining assets to pay off claims with respect to pre-existing insurance risks on its books. Such circumstances also include, for example, the application to the company of specific requirements with respect to capital and surplus relating to insurance liabilities imposed by a rating agency as a condition of obtaining a rating necessary to write new insurance business for the current year.

Effective Dates

The provision applies to taxable years beginning after December 31, 2017.

California Law (Section 28 of Article XIII of the California Constitution and R&TC sections 18181 and 24995)

The provisions of Part VI of Subchapter P of Chapter 1 of Subtitle A (sections 1291 to 1298) of the IRC, relating to treatment of certain passive foreign investment companies, are specifically not applicable for California purposes.

Insurance companies are not subject to the income or franchise taxes that are administered by the FTB. Instead, insurance companies must be admitted to do business in California, and once admitted, they pay the gross premiums tax that is jointly administered by the BOE, Department of Insurance, and the SCO.

Impact on California Revenue

Not applicable.

Section	Section Title
14502	Repeal of Fair Market Value Method of Interest Expense Apportionment

New Federal Law (IRC section 864)

The provision prohibits members of a U.S. affiliated group from allocating interest expense on the basis of the fair market value of assets for purposes of IRC section 864(e). Instead, the members must allocate interest expense based on the adjusted tax basis of assets.

Effective Dates

The provision is effective for taxable years beginning after December 31, 2017.

California Law (R&TC sections 17951, 23040.1, and 25110)

Except as provided in R&TC sections 23040.1[1498] and 25110, federal rules for determining the source of income (IRC sections 861 to 865, including IRC section 864, relating to definitions and special rules) are not applicable for California franchise or income tax purposes.

California exercises its taxing powers based on two jurisdictional concepts: (1) the residency of the individual, and (2) the source of the income. Residents of California pay state taxes on all income received regardless of its geographical source. Nonresidents of California are taxed by California only on income derived from sources within California's boundaries ("source income").

Source income includes wages earned from services performed in California, gains from the disposition of property located in California, and profits from business transacted in California. Intangible income, such as investment interest, is considered to originate in the state in which the recipient resides at the time it is earned, unless it is earned in connection with a trade-or business.

Worldwide Unitary Method

California corporate taxpayers doing business both within and without California are required to compute their California franchise or income tax using the worldwide unitary method. Under this method, a corporate taxpayer's business income from both domestic and foreign unitary operations is considered in the calculation of the taxpayer's tax base, and a share of that business income is then "apportioned" to California using a formula. Income apportioned to California is subject to California franchise or income tax. The formula measures relative levels of business activity in the state by using the amount of the taxpayer's sales in California divided by the taxpayer's sales everywhere.[1499] This measure of activities is commonly called the "single sales-factor formula." The amount of sales from both domestic and foreign activities are included in the calculation of the apportionment formula. Generally, dividends paid from one member to another within the unitary group from unitary earnings are eliminated from tax computations under R&TC section 25106.

California Water's-Edge Election

As an alternative to the worldwide unitary method, California law allows corporations to elect to determine the business income of their combined reporting group on a "water's-edge" basis. In general, the water's-edge method excludes foreign corporations from the calculation of business income. An exception to this general rule is a foreign (non-U.S.) corporation with income that is effectively connected with the conduct of a trade or business within the United States (ECI), and the average of its property, payroll, and sales factors within the United States is less than 20 percent. The income and factors of such foreign corporation are included in a water's-edge

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[1498] IRC section 864(b)(2)(A)(ii), relating to trading in securities for a taxpayer's own account.
[1499] An apportioning trade or business conducting certain qualified business activities is required to use an evenly weighted three-factor formula consisting of property, payroll, and sales to apportion its business income to California. (R&TC section 25128.)

combined report to the extent of its ECI and related factors assignable to a location within the U.S.[1500]

R&TC section 25110 provides that federal income tax laws apply to determine that foreign corporation's ECI to be included in a water's-edge combined report.[1501] Regulations adopted under R&TC section 25110 specifically requires the source of the ECI be determined in accordance with the sourcing rules set forth in IRC sections 861 through 865, including IRC section 864.[1502] As a result, the provision requiring members of a U.S. affiliated group to allocate interest expense based on the adjusted tax basis of assets is applicable with respect to water's-edge elections for taxable years beginning after December 31, 2017.

Impact on California Revenue

Estimated Conformity Revenue Impact of Repeal of Fair Market Value Method of Interest Expense Apportionment For Taxable Years Beginning On or After January 1, 2018 Enactment Assumed After June 30, 2018			
2017-18	2018-19	2019-20	2020-21
N/A	$1,200,000	$1,300,000	$1,000,000

[1500] R&TC section 25110(a)(2)(A)(i).
[1501] R&TC section 25110(a)(2)(A)(i) provides, in pertinent part, "[i]ncome of that corporation derived from or attributable to sources within the United States as determined by federal income tax laws . . . ."
[1502] Cal. Code Regs., tit. 18, section 25110(d)(2)(F)1.a.

EXHIBIT A – 2017 MISCELLANEOUS FEDERAL ACTS IMPACTING THE IRC NOT REQUIRING A CALIFORNIA RESPONSE

Public Law 115-63, Disaster Tax Relief and Airport and Airway Extension Act of 2017.

IRC Section	Public Law No.	Act Section No.	131 Stat. Page
1	115-63	1(a)	1168
4081	115-63	202 (a)	1171
4083	115-63	202 (c)(1)	1171
4261	115-63	202 (b)(1)	1171
4261	115-63	202 (c)(2)	1171
4271	115-63	202 (b)(2)	1171
9502	115-63	201	1171

EXHIBIT B – EXPIRING TAX PROVISIONS

California Sunset[1503]	California Sections	Federal Section	Federal Sunset	Description
12/31/18	17138.2 & 24308.2	N/A	N/A	Exclusion of Rebate Incentives for Expenses of Participating in a Turf Removal Water Conservation Program
12/31/18	17141.3	N/A	N/A	Exclusion of Reimbursement for Federal Taxes Imposed on Health Benefits for Same-Sex Spouses and Domestic Partners
12/31/18	19551.1 & 19551.5	N/A	N/A	FTB Reciprocal Agreements with Cities and Counties for Tax Information
06/30/19	24330	N/A	N/A	Exclusion of Income Received from Managed Care Organization
12/31/19	17144.7	N/A	N/A	Student Loan Forgiveness Debt Relief
12/31/19	18761 - 18766	N/A	N/A	Voluntary Contribution: California Alzheimer's Disease and Related Disorders Research Fund
06/30/20	17053.30 & 23630	N/A	N/A	Natural Heritage Preservation Credit
12/31/20	17053.73 & 23626	N/A	N/A	New Employment Credit[1504]
12/31/20	18754 - 18754.3	N/A	N/A	Voluntary Contribution: California Sea Otter Fund
12/31/20	18801 - 18804	N/A	N/A	Voluntary Contribution: California Firefighters' Memorial Fund
12/31/20	18805 - 18808	N/A	N/A	Voluntary Contribution: California Peace Officer Memorial Foundation Fund

1503 In general, this is the last date in the last taxable year to which the provision applies. Fiscal years beginning within this taxable year are, in general, also covered by the provision. In some cases, the repeal date of the section is listed or the expiration applies to transactions occurring after this date.

1504 The new employment credit law sections (R&TC sections 17053.73 and 23626) are repealed on December 1, 2024. Those law sections generally apply to taxable years beginning on or after January 1, 2014, and before January 1, 2021; however, they continue to be operative for taxable years beginning on or after January 1, 2021, but only with respect to qualified full-time employees who commence employment with a qualified taxpayer in a designated census tract or former enterprise zone in a taxable year beginning before January 1, 2021.

California Sunset	California Section	Federal Section	Federal Sunset	Description
12/31/21	17053.88.5 & 23688.5	N/A	N/A	Agricultural Donations to a Food Bank Credit
12/31/21	18901 - 18901.3	N/A	N/A	Voluntary Contribution: Prevention of Animal Homelessness and Cruelty Fund
12/31/22	17053.87 & 23687	N/A	N/A	College Access Tax Credit
12/31/22	18706-18709	N/A	N/A	Voluntary Contribution: Special Olympics Fund
12/31/22	18711-18714	N/A	N/A	Voluntary Contribution: California Domestic Violence Victims Fund
12/31/22	18735-18738	N/A	N/A	Voluntary Contribution: Revive the Salton Sea Fund
12/31/22	18781-18784	N/A	N/A	Voluntary Contribution: Type 1 Diabetes Research Fund
12/31/22	18897-18898	N/A	N/A	Voluntary Contribution: School Supplies for Homeless Children Fund
12/31/23	17207.14 & 24347.14	N/A	N/A	Automatic Disaster Loss Treatment for Areas Proclaimed by the Governor to Be in a State of Emergency
12/31/24	17059.2 & 23689	N/A	N/A	California Competes Tax Credit
12/31/24	18730 – 18733	N/A	N/A	Voluntary Contribution: California Senior Citizen Advocacy Voluntary Tax Contribution Fund
12/31/24	18741 - 18744	N/A	N/A	Voluntary Contribution: Rare and Endangered Species Preservation Voluntary Tax Contribution Program
12/31/24	18745 - 18748	N/A	N/A	Voluntary Contribution: Protect Our Coast and Oceans Voluntary Tax Contribution Fund
12/31/24	18862 - 18864	N/A	N/A	Voluntary Contribution: California Cancer Research Voluntary Tax Contribution Fund
12/31/24	18891 - 18894	N/A	N/A	Voluntary Contribution: Keep Arts in Schools Voluntary Tax Contribution Fund

EXHIBIT B – EXPIRING TAX PROVISIONS

California Sunset	California Section	Federal Section	Federal Sunset	Description
01/01/25	18791 - 18796	N/A	N/A	Voluntary Contribution: California Breast Cancer Research Voluntary Tax Contribution Fund
12/31/25	18416.5	N/A	N/A	Allow Electronic Communication to Taxpayers to Inform of Tax Change
12/31/25	18851 - 18855	N/A	N/A	Voluntary Contribution: Emergency Food for Families Voluntary Tax Contribution Fund
12/31/25	18900.40 - 18900.43	N/A	N/A	Voluntary Contribution: Habitat for Humanity Voluntary Tax Contribution Fund
12/31/30	23636	N/A	N/A	New Advanced Strategic Aircraft Credit

EXHIBIT C – REVENUE TABLES[1505]

Assumed Enactment after June 30, 2018

Table 1 – Disaster Tax Relief and Airport and Airway Extension Act of 2017 (Public Law 115-63)					
Act Section	**Provision**	**2017-18**	**2018-19**	**2019-20**	**2020-21**
501	Definitions	N/A	N/A	N/A	N/A
502	Special Disaster-Related Rules for Use of Retirement Funds	Baseline	Baseline	Baseline	Baseline
503	Disaster-Related Employment Relief	N/A	N/A	N/A	N/A
504	Additional Disaster-Related Tax Relief Provisions	N/A	N/A	N/A	N/A

Table 2 – An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018 (Public Law 115-97)					
Act Section	**Provision**	**2017-18**	**2018-19**	**2019-20**	**2020-21**
11001	Modification Of Rates[1506]	N/A	$300 million	$180 million	$180 million
11002	Inflation Adjustments Based on Chained CPI	N/A	N/A	N/A	N/A
11011	Deduction for Qualified Business Income of Pass-Thru Entities	N/A	- $3.7 billion	- $2.6 billion	- $2.7 billion
11012	Limitation on Losses for Taxpayers Other Than Corporations	N/A	$1.1 billion	$800 million	$800 million
11021	Increase in Standard Deduction	N/A	N/A	N/A	N/A
11022	Increase in and Modification of Child Tax Credit	N/A	N/A	N/A	N/A
11023	Increased Limitation for Certain Charitable Contributions	N/A	- $22 million	- $15 million	- $15 million

[1505] These estimates do not consider the net final payment method of accrual for personal income taxpayers.
[1506] Revenue impacts are only for the Tax on Unearned Income of Children (Kiddie Tax). All other provisions in Section 11001 are not applicable.

Act Section	Provision	2017-18	2018-19	2019-20	2020-21
11024	Increased Contributions to ABLE Accounts	N/A	- $400,000	- $200,000	- $200,000
11025	Rollovers to ABLE Programs From 529 Programs	N/A	- $450,000	- $200,000	- $200,000
11026	Treatment of Certain Individuals Performing Services in the Sinai Peninsula of Egypt	- $500,000	- $250,000	- $250,000	- $250,000
11027	Temporary Reduction in Medical Expense Deduction Floor	N/A	N/A	N/A	N/A
11028	Relief for 2016 Disaster Areas	Baseline	Baseline	Baseline	Baseline
11031	Treatment of Student Loans Discharged on Account of Death or Disability[1507]	N/A	- $1 million	- $500,000	- $500,000
11032	529 Account Funding for Elementary and Secondary Education	N/A	- $1.7 million	- $900,000	- $900,000
11041	Suspension of Deduction for Personal Exemptions	N/A	N/A	N/A	N/A
11042	Limitation on Deduction for State and Local, Etc. Taxes	N/A	$550 million	$350 million	$360 million
11043	Limitation on Deduction for Qualified Residence Interest	N/A	$800 million	$550 million	$600 million
11044	Modification of Deduction for Personal Casualty Losses	N/A	$25 million	$16 million	$17 million
11045	Suspension of Miscellaneous Itemized Deductions	N/A	$2.2 billion	$1.5 billion	$1.6 billion
11046	Suspension of Overall Limitation on Itemized Deductions	N/A	- $1.8 billion	- $1.2 billion	- $1.3 billion
11047	Suspension of Exclusion for Qualified Bicycle Commuting Reimbursement	N/A	$450,000	$200,000	$200,000
11048	Suspension of Exclusion for Qualified Moving Expense Reimbursement	N/A	$42 million	$27 million	$27 million
11049	Suspension of Deduction for Moving Expenses	N/A	$48 million	$32 million	$33 million

[1507] R&TC section 17144.7 allows this exclusion for taxable years beginning after December 31, 2014, and before January 1, 2020.

EXHIBIT C – REVENUE TABLES

Act Section	Provision	2017-18	2018-19	2019-20	2020-21
11050	Limitation on Wagering Losses	N/A	$1.7 million	$900,000	$900,000
11051	Repeal of Deduction for Alimony Payments	N/A	$4.9 million	$9.4 million	$16 million
11061	Increase in Estate and Gift Tax Exemption	N/A	N/A	N/A	N/A
11071	Extension of Time Limit for Contesting IRS Levy	N/A	N/A	N/A	N/A
11081	Elimination of Shared Responsibility Payment for Individuals Failing to Maintain Minimum Essential Coverage	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes
12001	Repeal of Tax for Corporations	N/A	- $170 million	- $160 million	- $150 million
12002	Credit for Prior Year Minimum Tax Liability of Corporations	N/A	- $600 million	- $270 million	- $160 million
12003	Increased Exemption for Individuals	N/A	N/A	N/A	N/A
13001	21-Percent Corporate Tax Rate	N/A	N/A	N/A	N/A
13002	Reduction in Dividend Received Deductions to Reflect Lower Corporate Income Tax Rates	N/A	N/A	N/A	N/A
13101	Modifications of Rules for Expensing Depreciable Business Assets	N/A	- $200,000	- $100,000	- $70,000
13102	Small Business Accounting Method Reform and Simplification	N/A	- $360 million	- $190 million	- $90 million
13201	Temporary 100-Percent Expensing for Certain Business Assets	N/A	N/A	N/A	N/A
13202	Modifications to Depreciation Limitations on Luxury Automobiles and Personal Use Property	N/A	- $35 million	- $40 million	- $45 million

Act Section	Provision	2017-18	2018-19	2019-20	2020-21
13203	Modifications of Treatment of Certain Farm Property	N/A	- $1.3 million	- $1 million	- $1.8 million
13204	Applicable Recovery Period for Real Property	N/A	- $700,000	- $950,000	- $1,500,000
13205	Use of Alternative Depreciation System for Electing Farming Businesses	Included in Section 13203	Included in Section 13203	Included in Section 13203	Included in Section 13203
13206	Amortization of Research and Experimental Expenditures[1508]	N/A	N/A	N/A	N/A
13207	Expensing of Certain Costs of Replanting Citrus Plants Lost by Reason of Casualty	N/A	- $400,000	- $200,000	- $200,000
13221	Certain Special Rules for Taxable Year of Inclusion	N/A	$100 million	$90 million	$80 million
13301	Limitation on Deduction for Interest	N/A	$650 million	$650 million	$650 million
13302	Modification of Net Operating Loss Deduction	$600 million	$750 million	$650 million	$650 million
13303	Like-Kind Exchanges of Real Property	N/A	$130 million	$130 million	$170 million
13304	Limitation on Deduction by Employers of Expenses for Fringe Benefits	N/A	$200 million	$150 million	$150 million
13305	Repeal of Deduction for Income Attributable to Domestic Production Activities	N/A	N/A	N/A	N/A
13306	Denial of Deduction for Certain Fines, Penalties, and Other Amounts	N/A	$600,000	$400,000	$350,000
13307	Denial of Deduction for Settlements Subject to Nondisclosure Agreements Paid in Connection with Sexual Harassment or Sexual Abuse	N/A	$300,000	$200,000	$200,000
13308	Repeal of Deduction for Local Lobbying Expenses	N/A	$4.4 million	$3.9 million	$3.7 million

[1508] The impact to the general fund would be a revenue gain for taxable years beginning on or after January 1, 2022.

EXHIBIT C – REVENUE TABLES

Act Section	Provision	2017-18	2018-19	2019-20	2020-21
13309	Recharacterization of Certain Gains in the Case of Partnership Profits Interests Held in Connection with Performance of Investment Services[1509]	$0	$0	$0	$0
13310	Prohibition on Cash, Gift Cards, and Other Nontangible Personal Property as Employee Achievement Awards	N/A	$450,000	$200,000	$200,000
13311	Elimination of Deduction for Living Expenses Incurred by Members of Congress	N/A	$400,000	$200,000	$200,000
13312	Certain Contributions by Governmental Entities not Treated as Contributions to Capital	N/A	$8.1 million	$13 million	$21 million
13313	Repeal of Rollover of Publicly Traded Securities Gain into Specialized Small Business Investment Companies	Baseline	Baseline	Baseline	Baseline
13314	Certain Self-Created Property not Treated as a Capital Asset	N/A	N/A	N/A	N/A
13401	Modification of Orphan Drug Credit	N/A	N/A	N/A	N/A
13402	Rehabilitation Credit Limited to Certified Historic Structures	N/A	N/A	N/A	N/A
13403	Employer Credit for Paid Family and Medical Leave	N/A	N/A	N/A	N/A
13404	Repeal of Tax Credit Bonds	N/A	N/A	N/A	N/A
13501	Treatment of Gain or Loss of Foreign Persons from Sale or Exchange of Interests in Partnerships Engaged in Trade or Business Within the United States	Baseline	Baseline	Baseline	Baseline
13502	Modify Definition of Substantial Built-In Loss in the Case of Transfer of Partnership Interest	N/A	- $1.1 million	$2.9 million	$4.5 million

[1509] Because California does not have preferential tax rates for capital gain income the recharacterization of certain gains in the case of partnership profits interests held in connection with performance of investment services from long term to short term would have no revenue impact.

Act Section	Provision	2017-18	2018-19	2019-20	2020-21
13503	Charitable Contributions and Foreign Taxes Taken into Account in Determining Limitation on Allowance of Partner's Share of Loss	N/A	$6.3 million	$4.5 million	$4.5 million
13504	Repeal of Technical Termination of Partnerships	N/A	$12 million	$5.8 million	$5.3 million
13511	Net Operating Losses of Life Insurance Companies	N/A	N/A	N/A	N/A
13512	Repeal of Small Life Insurance Company Deduction	N/A	N/A	N/A	N/A
13513	Adjustment for Change in Computing Reserves	N/A	N/A	N/A	N/A
13514	Repeal of Special Rule for Distributions to Share- Holders from Pre-1984 Policyholders Surplus Account	N/A	N/A	N/A	N/A
13515	Modification of Proration Rules for Property and Casualty Insurance Companies	N/A	N/A	N/A	N/A
13516	Repeal of Special Estimated Tax Payments	N/A	N/A	N/A	N/A
13517	Computation of Life Insurance Tax Reserves	N/A	N/A	N/A	N/A
13518	Modification of Rules for Life Insurance Proration for Purposes of Determining the Dividends Received Deduction	N/A	N/A	N/A	N/A
13519	Capitalization of Certain Policy Acquisition Expenses	N/A	N/A	N/A	N/A
13520	Tax Reporting for Life Settlement Transactions	N/A	N/A	N/A	N/A
13521	Clarification of Tax Basis of Life Insurance Contracts	N/A	- $3.4 million	$1 million	$2.2 million
13522	Exception to Transfer for Valuable Consideration Rules	Included in Section 13521	Included in Section 13521	Included in Section 13521	Included in Section 13521
13523	Modification Of Discounting Rules for Property and Casualty Insurance Companies	N/A	N/A	N/A	N/A

Act Section	Provision	2017-18	2018-19	2019-20	2020-21
13531	Limitation on Deduction for FDIC Premiums	N/A	$47 million	$55 million	$50 million
13532	Repeal of Advance Refunding Bonds	N/A	N/A	N/A	N/A
13541	Expansion of Qualifying Beneficiaries of an Electing Small Business Trust	N/A	- $1.7 million	- $900,000	- $900,000
13542	Charitable Contribution Deduction for Electing Small Business Trusts	Included in Section 13541	Included in Section 13541	Included in Section 13541	Included in Section 13541
13543	Modification of Treatment of S Corporation Conversions to C Corporations	N/A	- $25 million	- $21 million	- $20 million
13601	Modification of Limitation on Excessive Employee Remuneration	N/A	$24 million	$35 million	$34 million
13602	Excise Tax on Excess Tax-Exempt Organization Executive Compensation	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes
13603	Treatment of Qualified Equity Grants	N/A	- $12 million	- $8 million	- $6.8 million
13604	Increase in Excise Tax Rate for Stock Compensation of Insiders in Expatriated Corporations	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes
13611	Repeal of Special Rule Permitting Recharacterization of Roth Conversions	Baseline	Baseline	Baseline	Baseline
13612	Modification of Rules Applicable to Length of Service Award Plans	Baseline	Baseline	Baseline	Baseline
13613	Extended Rollover Period for Plan Loan Offset Amounts	Baseline	Baseline	Baseline	Baseline
13701	Excise Tax Based on Investment Income of Private Colleges and Universities	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes
13702	Unrelated Business Taxable Income Separately Computed for Each Trade or Business Activity	N/A	$12 million	$11 million	$10 million

Act Section	Provision	2017-18	2018-19	2019-20	2020-21
13703	Unrelated Business Taxable Income Increased by Amount of Certain Fringe Benefit Expenses for Which Deduction Is Disallowed	Included in Section 13304	Included in Section 13304	Included in Section 13304	Included in Section 13304
13704	Repeal of Deduction for Amounts Paid in Exchange for College Athletic Event Seating Rights	N/A	$5.1 million	$2.7 million	$2.7 million
13705	Repeal Of Substantiation Exception in Case of Contributions Reported by Donee	N/A	Negligible	Negligible	Negligible
13801	Production Period for Beer, Wine, and Distilled Spirits	N/A	- $4.1 million	- $2.1 million	- $700,000
13802	Reduced Rate of Excise Tax on Beer	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes
13803	Transfer of Beer Between Bonded Facilities	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes
13804	Reduced Rate of Excise Tax on Certain Wine	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes
13805	Adjustment of Alcohol Content Level for Application of Excise Tax Rates	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes
13806	Definition of Mead and Low Alcohol by Volume Wine	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes
13807	Reduced Rate of Excise Tax on Certain Distilled Spirits	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes
13808	Bulk Distilled Spirits	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes
13821	Modification of Tax Treatment of Alaska Native Corporations and Settlement Trusts	N/A	N/A	N/A	N/A
13822	Amounts Paid for Aircraft Management Services	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes	The FTB Does Not Administer These Types of Excise Taxes

Act Section	Provision	2017-18	2018-19	2019-20	2020-21
13823	Opportunity Zones	N/A	N/A	N/A	N/A
14101	Deduction for Foreign-Source Portion of Dividends Received by Domestic Corporations from Specified 10-Percent Owned Foreign Corporations	N/A	N/A	N/A	N/A
14102	Special Rules Relating to Sales or Transfers Involving Specified 10-Percent Owned Foreign Corporations	N/A	Indeterminate [1510]	Indeterminate [1511]	Indeterminate [1512]
14103	Treatment of Deferred Foreign Income upon Transition to Participation Exemption System of Taxation	Baseline	Baseline	Baseline	Baseline
14201	Current Year Inclusion of Global Intangible Low-Taxed Income by United States Shareholders	N/A	N/A	N/A	N/A
14202	Deduction for Foreign-Derived Intangible Income and Global Intangible Low-Taxed Income	N/A	N/A	N/A	N/A
14211	Elimination of Inclusion of Foreign Base Company Oil Related Income	Baseline	Baseline	Baseline	Baseline
14212	Repeal of Inclusion Based on Withdrawal of Previously Excluded Subpart F Income From Qualified Investment	Baseline	Baseline	Baseline	Baseline
14213	Modification of Stock Attribution Rules for Determining Status as a Controlled Foreign Corporation	Baseline	Baseline	Baseline	Baseline
14214	Modification of Definition of United States Shareholder	Baseline	Baseline	Baseline	Baseline
14215	Elimination of Requirement that Corporation Must Be Controlled for 30 Days Before Subpart F Inclusions Apply	Baseline	Baseline	Baseline	Baseline
14221	Limitations on Income Shifting Through Intangible Property Transfers	N/A	$5.4 million	$3.9 million	$3.5 million

[1510] There would be an indeterminate revenue impact from this provision that could be a revenue gain or loss depending upon the taxpayer's circumstances.
[1511] Ibid.
[1512] Ibid.

Act Section	Provision	2017-18	2018-19	2019-20	2020-21
14222	Certain Related Party Amounts Paid or Accrued in Hybrid Transactions or with Hybrid Entities	N/A	N/A	N/A	N/A
14223	Shareholders of Surrogate Foreign Corporations not Eligible for Reduced Rate on Dividends	N/A	N/A	N/A	N/A
14301	Repeal of Section 902 Indirect Foreign Tax Credits; Determination of Section 960 Credit on Current Year Basis	N/A	N/A	N/A	N/A
14302	Separate Foreign Tax Credit Limitation Basket for Foreign Branch Income	N/A	N/A	N/A	N/A
14303	Source of Income from Sales of Inventory Determined Solely on Basis of Production Activities	N/A	$900,000	$700,000	$600,000
14304	Election to Increase Percentage of Domestic Taxable Income Offset by Overall Domestic Loss Treated as Foreign Source	N/A	N/A	N/A	N/A
14401	Base Erosion and Anti-Abuse Tax	N/A	N/A	N/A	N/A
14501	Restriction on Insurance Business Exception to Passive Foreign Investment Company Rules	N/A	N/A	N/A	N/A
14502	Repeal of Fair Market Value Method of Interest Expense Apportionment	N/A	$1.2 million	$1.3 million	$1 million