

chair **Betty T. Yee**  
member **Malia M. Cohen**  
member **Keely Bosler**



STATE OF CALIFORNIA  
**Franchise Tax Board**

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Summary of Federal Income Tax Change  
2018

*Laws Affected*

Personal Income Tax Law

Corporation Tax Law

Administration of Franchise and Income Tax Laws

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## Summary of Federal Income Tax Changes

2018

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

Members of the Board:  
Betty T. Yee, Chair  
Malia M. Cohen, Member  
Keely Bosler, Member

Executive Officer: Selvi Stanislaus

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

# Summary of Federal Income Tax Changes – 2018

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# Summary of Federal Income Tax Changes – 2018

## EXECUTIVE SUMMARY

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

During 2018, the Internal Revenue Code (IRC) or its application by California was changed by:

<b>PUBLIC LAW</b>	<b>TITLE</b>	<b>DATE</b>
115-120	Federal Register Printing Savings Act of 2017	January 22, 2018
115-123	Bipartisan Budget Act of 2018	February 9, 2018
115-141	Consolidated Appropriations Act, 2018	March 23, 2018
115-271	SUPPORT for Patients and Communities Act	October 24, 2018
115-407	Veterans Benefits and Transition Act of 2018	December 31, 2018

## Summary of Federal Income Tax Changes – 2018

This report explains the new 2018 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            *2018 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 of the California Revenue and Taxation Code* - 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.

Federal Register Printing Savings Act of 2017  
Public Law 115-120, January 22, 2018

**Division D—Suspension of Certain Health-Related Taxes**

<u>Section</u>	<u>Section Title</u>
4001	Extension of Moratorium on Medical Device Excise Tax

Background

Effective for sales after December 31, 2012, a tax equal to 2.3 percent of the sale price is imposed on the sale of any taxable medical device by the manufacturer, producer, or importer of such device.<sup>1</sup> A taxable medical device is any device, as defined in section 201(h) of the Federal Food, Drug, and Cosmetic Act,<sup>2</sup> intended for humans. Regulations further define a medical device as one that is listed by the Food and Drug Administration (FDA) under section 510(j) of the Federal Food, Drug, and Cosmetic Act and 21 C.F.R. Part 807, pursuant to FDA requirements.<sup>3</sup>

The excise tax does not apply to eyeglasses, contact lenses, hearing aids, or any other medical device determined by the Secretary to be of a type that is generally purchased by the general public at retail for individual use (“retail exemption”). Regulations provide guidance on the types of devices that are exempt under the retail exemption. A device is exempt under these provisions if: (1) it is regularly available for purchase and use by individual consumers who are not medical professionals; and (2) the design of the device demonstrates that it is not primarily intended for use in a medical institution or office or by a medical professional.<sup>4</sup> Additionally, the regulations provide certain safe harbors for devices eligible for the retail exemption.<sup>5</sup>

The medical device excise tax is generally subject to the rules applicable to other manufacturers excise taxes. These rules include certain general manufacturers excise tax exemptions including the exemption for sales for use by the purchaser for further manufacture (or for resale to a second

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<sup>1</sup> IRC section 4191.

<sup>2</sup> 21 U.S.C. section 321. Section 201(h) defines device as “an instrument, apparatus, implement, machine, contrivance, implant, in vitro reagent, or other similar or related article, including any component, part, or accessory, which is (1) recognized in the official National Formulary, or the United States Pharmacopeia, or any supplement to them, (2) intended for use in the diagnosis of disease or other conditions, or in the cure, mitigation, treatment, or prevention of disease, in man or other animals, or (3) intended to affect the structure or any function of the body of man or other animals, and which does not achieve its primary intended purposes through chemical action within or on the body of man or other animals and which is not dependent upon being metabolized for the achievement of its primary intended purposes.”

<sup>3</sup> Treasury Regulation section 48.4191-2(a). The regulations also include as devices items that should have been listed as a device with the FDA as of the date the FDA notifies the manufacturer or importer that corrective action with respect to listing is required.

<sup>4</sup> Treasury Regulation section 48.4191-2(b)(2).

<sup>5</sup> Treasury Regulation section 48.4191-2(b)(2)(iii). The safe harbors include devices that are described as over-the-counter devices in relevant FDA classification headings as well as certain FDA device classifications listed in the regulations.



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Public Law 115-120, January 22, 2018

purchaser in further manufacture) or for export (or for resale to a second purchaser for export).<sup>6</sup> If a medical device is sold free of tax for resale to a second purchaser for further manufacture or for export, the exemption does not apply unless, within the six-month period beginning on the date of sale by the manufacturer, the manufacturer receives proof that the medical device has been exported or resold for use in further manufacturing.<sup>7</sup> In general, the exemption does not apply unless the manufacturer, the first purchaser, and the second purchaser are registered with the Secretary of the Treasury (Secretary). Foreign purchasers of articles sold or resold for export are exempt from the registration requirement.

The lease of a medical device is generally considered to be a sale of such device.<sup>8</sup> Special rules apply for the imposition of tax to each lease payment. The use of a medical device subject to tax by manufacturers, producers, or importers of such device, is treated as a sale for the purpose of imposition of excise taxes.<sup>9</sup>

There are also rules for determining the price of a medical device on which the excise tax is imposed.<sup>10</sup> These rules provide for (1) the inclusion of containers, packaging, and certain transportation charges in the price, (2) determining a constructive sales price if a medical device is sold for less than the fair market price, and (3) determining the tax due in the case of partial payments or installment sales.

The Protecting Americans from Tax Hikes Act of 2015<sup>11</sup> (PATH Act) suspended the medical device tax for two years, for sales after December 31, 2015, and before January 1, 2018.

#### New Federal Law (IRC section 4191)

The provision suspends the medical device excise tax for one year, for sales after December 31, 2017, and before January 1, 2019.

#### Effective Dates

The provision applies to sales after December 31, 2017.

#### California Law (None)

The FTB does not administer these types of excise taxes.

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<sup>6</sup> IRC section 4221(a). Other general manufacturers excise tax exemptions (*i.e.*, the exemption for sales to purchasers for use as supplies for vessels or aircraft, to a state or local government, to a nonprofit educational organization, or to a qualified blood collector organization) do not apply to the medical device excise tax.

<sup>7</sup> IRC section 4221(b).

<sup>8</sup> IRC section 4217(a).

<sup>9</sup> IRC section 4218.

<sup>10</sup> IRC section 4216.

<sup>11</sup> Public Law 114-113, Division Q, Section 174(a), enacted December 18, 2015.

Impact on California Revenue

The FTB does not administer these types of excise taxes.

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<u>Section</u>	<u>Section Title</u>
4002	Delay in Implementation of Excise Tax on High Cost Employer-Sponsored Health Coverage

Background

**In General**

For taxable years beginning after 2017, an excise tax is imposed on insurers if the aggregate value of employer-sponsored health insurance coverage for an employee (including, for purposes of the provision, any former employee, surviving spouse and any other primary insured individual) exceeds a threshold amount. The tax is equal to 40 percent of the aggregate value that exceeds the threshold amount. For 2018, the threshold amount is \$10,200 for individual coverage and \$27,500 for family coverage, multiplied by the health cost adjustment percentage (as defined below) and increased by the age and gender adjusted excess premium amount (as defined below).

The health cost adjustment percentage is designed to increase the thresholds in the event that the actual growth in the cost of U.S. health care between 2010 and 2018 exceeds the projected growth for that period. The health cost adjustment percentage is equal to 100 percent plus the excess, if any, of the percentage by which the per employee cost of coverage under the Blue Cross/Blue Shield standard benefit option under the Federal Employees Health Benefits Plan (“standard FEHBP coverage”)<sup>12</sup> for plan year 2018 (as determined using the benefit package for standard FEHBP coverage for plan year 2010) exceeds the per employee cost of standard FEHBP coverage for plan year 2010, over 55 percent. In 2019, the threshold amounts, after application of the health cost adjustment percentage in 2018, if any, are indexed to the Consumer Price Index for All Urban Consumers (CPI-U), as determined by the Department of Labor, plus one percentage point, rounded to the nearest \$50. In 2020 and thereafter, the threshold amounts are indexed to the CPI-U as determined by the Department of Labor, rounded to the nearest \$50.

For each employee (other than for certain retirees and employees in high-risk professions, whose thresholds are adjusted under rules described below), the age and gender adjusted excess premium amount is equal to the excess, if any, of the premium cost of standard FEHBP coverage for the type of coverage provided to the individual if priced for the age and gender characteristics

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<sup>12</sup> For purposes of determining the health cost adjustment percentage in 2018 and the age and gender adjusted excess premium amount in any year, in the event the standard Blue Cross/Blue Shield option is not available under the Federal Employees Health Benefit Plan for such year, the Secretary will determine the health cost adjustment percentage by reference to a substantially similar option available under the Federal Employees Health Benefit Plan for that year.

Federal Register Printing Savings Act of 2017  
Public Law 115-120, January 22, 2018

of all employees of the individual's employer, over the premium cost, determined under procedures prescribed by the Secretary, for that coverage if priced for the age and gender characteristics of the national workforce.

For example, if the growth in the cost of health care during the period between 2010 and 2018, calculated by reference to the growth in the per employee cost of standard FEHBP coverage during that period (holding benefits under the standard FEHBP coverage constant during the period) is 57 percent, the threshold amounts for 2018 will be \$10,200 for individual coverage and \$27,500 for family coverage, multiplied by 102 percent (100 percent plus the excess of 57 percent over 55 percent), or \$10,404 for individual coverage and \$28,050 for family coverage. In 2019, the new threshold amounts of \$10,404 for individual coverage and \$28,050 for family coverage are indexed to the CPI-U, plus one percentage point, rounded to the nearest \$50. Beginning in 2020, the threshold amounts are indexed to the CPI-U, rounded to the nearest \$50.

The new threshold amounts (as indexed) are then increased for any employee by the age and gender adjusted excess premium amount, if any. For an employee with individual coverage in 2019, if standard FEHBP coverage priced for the age and gender characteristics of the workforce of the employee's employer is \$11,400 and the Secretary estimates that the premium cost for individual standard FEHBP coverage priced for the age and gender characteristics of the national workforce is \$10,500, the threshold for that employee is increased by \$900 (\$11,400 less \$10,500) to \$11,304 (\$10,404 plus \$900).

The excise tax is imposed pro rata on the issuers of the insurance. In the case of a self-insured group health plan, a Health Flexible Spending Account (FSA) or a Health Reimbursement Account (HRA), the excise tax is paid by the entity that administers benefits under the plan or arrangement ("plan administrator"). Where the employer acts as plan administrator to a self-insured group health plan, a Health FSA or an HRA, the excise tax is paid by the employer. Where an employer contributes to an HSA or an Archer Medical Savings Account (MSA), the employer is responsible for payment of the excise tax, as the insurer.

Employer-sponsored health insurance coverage is health coverage under any group health plan offered by an employer to an employee without regard to whether the employer provides the coverage (and thus the coverage is excludable from the employee's gross income) or the employee pays for the coverage with after-tax dollars. Employer-sponsored health insurance coverage includes coverage under any group health plan established and maintained primarily for the civilian employees of the federal government or any of its agencies or instrumentalities and, except as provided below, of any state government or political subdivision thereof or by any of agencies or instrumentalities of such government or subdivision.

Employer-sponsored health insurance coverage includes both fully-insured and self-insured health coverage excludable from the employee's gross income, including, in the self-insured context, on-site medical clinics that offer more than a de minimis amount of medical care to employees and executive physical programs. In the case of a self-employed individual, employer-sponsored health insurance coverage is coverage for any portion of which a deduction is allowable to the self-employed individual under IRC section 162(l).

In determining the amount by which the value of employer-sponsored health insurance coverage exceeds the threshold amount, the aggregate value of all employer-sponsored health insurance coverage is taken into account, including coverage in the form of reimbursements under a Health FSA or an HRA, contributions to an HSA or Archer MSA, and, except as provided below, other supplementary health insurance coverage. The value of employer-sponsored coverage for long term care and the following benefits described in IRC section 9832(c)(1) that are excepted from the portability, access and renewability requirements of the Health Insurance Portability and Accountability Act (HIPAA) are not taken into account in the determination of whether the value of health coverage exceeds the threshold amount: (1) coverage only for accident or disability income insurance, or any combination of these coverage's; (2) coverage issued as a supplement to liability insurance; (3) liability insurance, including general liability insurance and automobile liability insurance; (4) workers' compensation or similar insurance; (5) automobile medical payment insurance; (5) credit-only insurance; and (6) other similar insurance coverage, specified in regulations, under which benefits for medical care are secondary or incidental to other insurance benefits.

The value of employer-sponsored health insurance coverage does not include the value of independent, non-coordinated coverage described in IRC section 9832(c)(3) as excepted from the portability, access and renewability requirements of HIPAA if that coverage is purchased exclusively by the employee with after-tax dollars (or, in the case of a self-employed individual, for which a deduction under IRC section 162(l) is not allowable). The value of employer-sponsored health insurance coverage does include the value of such coverage if any portion of the coverage is employer-provided (or, in the case of a self-employed individual, if a deduction is allowable for any portion of the payment for the coverage). Coverage described in IRC section 9832(c)(3) is coverage only for a specified disease or illness or for hospital or other fixed indemnity health coverage. Fixed indemnity health coverage pays fixed dollar amounts based on the occurrence of qualifying events, including but not limited to the diagnosis of a specific disease, an accidental injury or a hospitalization, provided that the coverage is not coordinated with other health coverage.

Finally, the value of employer-sponsored health insurance coverage does not include any coverage under a separate policy, certificate, or contract of insurance which provides benefits substantially all of which are for treatment of the mouth (including any organ or structure within the mouth) or for treatment of the eye.

## **Calculation and Proration of Excise Tax and Reporting Requirements**

### *Applicable Threshold*

In general, the individual threshold applies to any employee covered by employer-sponsored health insurance coverage. The family threshold applies to an employee only if such individual and at least one other beneficiary are enrolled in coverage other than self-only coverage under an employer-sponsored health insurance plan that provides minimum essential coverage (as determined for purposes of the individual responsibility requirements) and under which the benefits provided do not vary based on whether the covered individual is the employee or other beneficiary.

Federal Register Printing Savings Act of 2017  
Public Law 115-120, January 22, 2018

For all employees covered by a multiemployer plan, the family threshold applies regardless of whether the individual maintains individual or family coverage under the plan. For purposes of the provision, a multiemployer plan is an employee health benefit plan to which more than one employer is required to contribute, which is maintained pursuant to one or more collective bargaining agreements between one or more employee organizations and more than one employer.

*Amount of Applicable Premium*

The aggregate value of all employer-sponsored health insurance coverage, including any supplementary health insurance coverage not excluded from the value of employer-sponsored health insurance, is generally calculated in the same manner as the applicable premiums for the taxable year for the employee determined under the rules for Consolidated Omnibus Budget Reconciliation Act (COBRA) continuation coverage, but without regard to the excise tax. If the plan provides for the same COBRA continuation coverage premium for both individual coverage and family coverage, the plan is required to calculate separate individual and family premiums for this purpose. In determining the coverage value for retirees, employers may elect to treat pre-65 retirees together with post-65 retirees.

*Value of Coverage in the Form of Health FSA Reimbursements*

In the case of a Health FSA from which reimbursements are limited to the amount of the salary reduction, the value of employer-sponsored health insurance coverage is equal to the dollar amount of the aggregate salary reduction contributions for the year. To the extent that the Health FSA provides for employer contributions in excess of the amount of the employee's salary reduction, the value of the coverage generally is determined in the same manner as the applicable premium for COBRA continuation coverage. If the plan provides for the same COBRA continuation coverage premium for both individual coverage and family coverage, the plan is required to calculate separate individual and family premiums for this purpose.

*Amount Subject to the Excise Tax and Reporting Requirement*

The amount subject to the excise tax on high-cost employer-sponsored health insurance coverage for each employee is the sum of the aggregate premiums for health insurance coverage, the amount of any salary reduction contributions to a Health FSA for the taxable year, and the dollar amount of employer contributions to an HSA or an Archer MSA, minus the dollar amount of the threshold. The aggregate premiums for health insurance coverage include all employer-sponsored health insurance coverage, including coverage for any supplementary health insurance coverage. The applicable premium for health coverage provided through an HRA is also included in this aggregate amount.

Under a separate rule, an employer is required to disclose the aggregate premiums for health insurance coverage for each employee on his or her annual Form W-2.

The excise tax is allocated pro rata among the insurers, with each insurer responsible for payment of the excise tax on an amount equal to the amount subject to the total excise tax multiplied by a fraction, the numerator of which is the amount of employer-sponsored health insurance coverage

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Public Law 115-120, January 22, 2018

provided by that insurer to the employee and the denominator of which is the aggregate value of all employer-sponsored health insurance coverage provided to the employee. In the case of a self-insured group health plan, a Health FSA or an HRA, the excise tax is allocated to the plan administrator. If an employer contributes to an HSA or an Archer MSA, the employer is responsible for payment of the excise tax, as the insurer. The employer is responsible for calculating the amount subject to the excise tax allocable to each insurer and plan administrator and for reporting these amounts to each insurer, plan administrator and the Secretary, in such form and at such time as the Secretary may prescribe. Each insurer and plan administrator is then responsible for calculating, reporting and paying the excise tax to the Internal Revenue Service (IRS) on such forms and at such time as the Secretary may prescribe.

For example, if in 2018 an employee elects family coverage under a fully-insured health care policy covering major medical and dental with a value of \$31,000, the health cost adjustment percentage for that year is 100 percent, and the age and gender adjusted excess premium amount for the employee is \$600, the amount subject to the excise tax is \$2,900 (\$31,000 less the threshold of \$28,100 (\$27,500 multiplied by 100 percent and increased by \$600)).

The employer reports \$2,900 as taxable to the insurer, which calculates and remits the excise tax to the IRS.

Alternatively, if in 2018 an employee elects family coverage under a fully-insured major medical policy with a value of \$28,500 and contributes \$2,500 to a Health FSA, the employee has an aggregate health insurance coverage value of \$31,000. If the health cost adjustment percentage for that year is 100 percent and the age and gender adjusted excess premium amount for the employee is \$600, the amount subject to the excise tax is \$2,900 (\$31,000 less the threshold of \$28,100 (\$27,500 multiplied by 100 percent and increased by \$600)). The employer reports \$2,666 ( $\$2,900 \times \$28,500 / \$31,000$ ) as taxable to the major medical insurer which then calculates and remits the excise tax to the IRS. If the employer uses a third-party administrator for the Health FSA, the employer reports \$234 ( $\$2,900 \times \$2,500 / \$31,000$ ) to the administrator and the administrator calculates and remits the excise tax to the IRS. If the employer is acting as the plan administrator of the Health FSA, the employer is responsible for calculating and remitting the excise tax of \$234 to the IRS.

*Penalty for Underreporting Liability for Tax to Insurers*

If the employer reports to insurers, plan administrators and the IRS a lower amount of insurance cost subject to the excise tax than required, the employer is subject to a penalty equal to the sum of any additional excise tax that each such insurer and administrator would have owed if the employer had reported correctly, and interest attributable to that additional excise tax as determined under IRC section 6621 from the date that the tax was otherwise due to the date paid by the employer. This may occur, for example, if the employer undervalues the aggregate premium and thereby lowers the amount subject to the excise tax for all insurers and plan administrators (including the employer, when acting as plan administrator of a self-insured plan). The penalty will not apply if it is established to the satisfaction of the Secretary that the employer neither knew, nor, exercising reasonable diligence, would have known, that the failure existed.



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In addition, no penalty will be imposed on any failure corrected within the 30-day period beginning on the first date that the employer knew, or exercising reasonable diligence, would have known, that the failure existed, so long as the failure is due to reasonable cause and not to willful neglect.

All or part of the penalty may be waived by the Secretary in the case of any failure due to reasonable cause and not to willful neglect, to the extent that the payment of the penalty would be excessive or otherwise inequitable relative to the failure involved.

The penalty is in addition to the amount of excise tax owed, which may not be waived.

*Increased Thresholds for Certain Retirees and Individuals in High-Risk Professions*

The threshold amounts are increased for an individual who has attained the age of 55 who is ineligible for Medicare and receiving employer-sponsored retiree health coverage or who is covered by a plan sponsored by an employer the majority of whose employees covered by the plan are engaged in a high-risk profession or employed to repair or install electrical and telecommunications lines. For these individuals, the threshold amount in 2018 is increased by: (1) \$1,650 for individual coverage or \$3,450 for family coverage; and (2) the age and gender adjusted excess premium amount (as defined above). In 2019, the additional \$1,650 and \$3,450 amounts are indexed to the CPI-U, plus one percentage point, rounded to the nearest \$50. In 2020 and thereafter, the additional threshold amounts are indexed to the CPI-U, rounded to the nearest \$50.

For purposes of this rule, employees considered to be engaged in a high-risk profession are law enforcement officers, employees who engage in fire protection activities, individuals who provide out-of-hospital emergency medical care (including emergency medical technicians, paramedics, and first responders), individuals whose primary work is longshore work, and individuals engaged in the construction, mining, agriculture (not including food processing), forestry, and fishing industries. A retiree with at least 20 years of employment in a high-risk profession is also eligible for the increased threshold.

An individual's threshold cannot be increased by more than \$1,650 for individual coverage or \$3,450 for family coverage (indexed as described above) and the age and gender adjusted excess premium amount, even if the individual would qualify for an increased threshold both on account of his or her status as a retiree over age 55 and as a participant in a plan that covers employees in a high-risk profession.

*Deductibility of Excise Tax*

The amount of the excise tax imposed is not deductible for federal income tax purposes.

*Regulatory Authority*

The Secretary is directed to prescribe such regulations as may be necessary to carry out the provision.

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New Federal Law (IRC section 4980I)

The provision delays the excise tax on high-cost employer-sponsored health coverage for two years, meaning it applies to taxable years beginning after December 31, 2021.

Effective Date

The provision is effective January 22, 2018.

California Law (None)

The FTB does not administer these types of excise taxes.

Impact on California Revenue

The FTB does not administer these types of excise taxes.

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<u>Section</u>	<u>Section Title</u>
4003	Suspension of Annual Fee on Health Insurance Providers

Background

Under present law, an annual fee applies to any covered entity engaged in the business of providing health insurance with respect to United States health risks. The fee applies for calendar years beginning after 2013; however, the fee was suspended<sup>13</sup> for the 2017 calendar year. The aggregate annual fee for all covered entities is the applicable amount. The applicable amount is \$8 billion for calendar year 2014, \$11.3 billion for calendar years 2015 and 2016, \$13.9 billion for calendar year 2017, and \$14.3 billion for calendar year 2018. For calendar years after 2018, the applicable amount is indexed to the rate of premium growth.

The annual payment date for a calendar year is determined by the Secretary, but in no event may be later than September 30 of that year.

Under present law, the aggregate annual fee is apportioned among the providers based on a ratio designed to reflect relative market share of U.S. health insurance business. For each covered entity, the fee for a calendar year is an amount that bears the same ratio to the applicable amount as the covered entity's net premiums written during the preceding calendar year with respect to health insurance for any United States health risk, bears to the aggregate net written premiums of all covered entities during such preceding calendar year with respect to such health insurance.

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<sup>13</sup> Consolidated Appropriations Act, 2016, Division P, Section 201, Public Law 114-113, enacted December 18, 2015.



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Present law requires the Secretary to calculate the amount of each covered entity's fee for the calendar year, determining the covered entity's net written premiums for the preceding calendar year with respect to health insurance for any United States health risk on the basis of reports submitted by the covered entity and through the use of any other source of information available to the Treasury Department. It is intended that the Treasury Department be able to rely on published aggregate annual statement data to the extent necessary, and may use annual statement data and filed annual statements that are publicly available to verify or supplement the reports submitted by covered entities.

“Net written premiums” is intended to mean premiums written, including reinsurance premiums written, reduced by reinsurance ceded, and reduced by ceding commissions. Net written premiums do not include amounts arising under arrangements that are not treated as insurance (i.e., in the absence of sufficient risk shifting and risk distribution for the arrangement to constitute insurance).<sup>14</sup>

The amount of net premiums written that are taken into account for purposes of determining a covered entity's market share is subject to dollar thresholds. A covered entity's net premiums written during the calendar year that are not more than \$25 million are not taken into account for this purpose. With respect to a covered entity's net premiums written during the calendar year that are more than \$25 million but not more than \$50 million, 50 percent are taken into account, and 100 percent of net premiums written in excess of \$50 million are taken into account.

After application of the above dollar thresholds, a special rule provides an exclusion, for purposes of determining an otherwise covered entity's market share, of 50 percent of net premiums written that are attributable to the exempt activities<sup>15</sup> of a health insurance organization that is exempt from federal income tax<sup>16</sup> by reason of being described in IRC section 501(c)(3) (generally, a public charity), IRC section 501(c)(4) (generally, a social welfare organization), IRC section 501(c)(26) (generally, a high-risk health insurance pool), or IRC section 501(c)(29) (a consumer operated and oriented plan (“CO-OP”) health insurance issuer).

A covered entity generally is an entity that provides health insurance with respect to United States health risks during the calendar year in which the fee under this section is due. Thus, for example, an insurance company subject to tax under Part I or II of IRC Subchapter L, an organization exempt from tax under IRC section 501(a), a foreign insurer that provides health insurance with respect to United States health risks, or an insurer that provides health insurance with respect to United States health risks under Medicare Advantage, Medicare Part D, or Medicaid, is a covered entity under present law except as provided in specific exceptions.

Specific exceptions are provided to the definition of a covered entity. A covered entity does not include an employer to the extent that the employer self-insures the health risks of its employees.

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<sup>14</sup> See *Helvering v. Le Gierse*, 312 U.S. 531 (1941).

<sup>15</sup> The exempt activities for this purpose are activities other than activities of an unrelated trade or business defined in IRC section 513.

<sup>16</sup> IRC section 501(m) provides that an organization described in IRC section 501(c)(3) or (4) is exempt from federal income tax only if no substantial part of its activities consists of providing commercial-type insurance. Thus, an organization otherwise described in IRC section 501(c)(3) or (4) that is taxable (under the federal income tax rules) by reason of IRC section 501(m) is not eligible for the 50-percent exclusion under the insurance fee.

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For example, a manufacturer that enters into a self-insurance arrangement with respect to the health risks of its employees is not treated as a covered entity. As a further example, an insurer that sells health insurance and that also enters into a self-insurance arrangement with respect to the health risks of its own employees is treated as a covered entity with respect to its health insurance business, but is not treated as a covered entity to the extent of the self-insurance of its own employees' health risks.

A covered entity does not include any governmental entity. For this purpose, it is intended that a governmental entity includes a county organized health system entity that is an independent public agency organized as a nonprofit under state law and that contracts with a state to administer state Medicaid benefits through local care providers or health maintenance organizations (HMOs).

A covered entity does not include an entity that: (1) qualifies as nonprofit under applicable state law; (2) meets the private inurement and limitation on lobbying provisions described in IRC section 501(c)(3); and (3) receives more than 80 percent of its gross revenue from government programs that target low-income, elderly, or disabled populations (including Medicare, Medicaid, the State Children's Health Insurance Plan ("SCHIP"), and dual-eligible plans).

A covered entity does not include an organization that qualifies as a voluntary employees' benefit association (VEBA) under IRC section 501(c)(9) that is established by an entity other than the employer (i.e., a union) for the purpose of providing health care benefits. This exclusion does not apply to multi-employer welfare arrangements ("MEWAs").

Under present law, all persons treated as a single employer under IRC section 52(a) or (b) or IRC section 414(m) or (o) are treated as a single covered entity (or as a single employer, for purposes of the rule relating to employers that self-insure the health risks of employees), and any otherwise applicable exclusion of foreign corporations under those rules is disregarded. However, the exceptions to the definition of a covered entity are applied on a separate-entity basis, not taking into account this rule. If more than one person is liable for payment of the fee by reason of being treated as a single covered entity, all such persons are jointly and severally liable for payment of the fee.

A U.S. health risk means the health risk of an individual who is a U.S. citizen, is a U.S. resident within the meaning of IRC section 7701(b)(1)(A) (whether or not located in the U.S.), or is located in the U.S., with respect to the period that the individual is located there. In general, it is intended that risks in the following lines of business reported on the annual statement as prescribed by the National Association of Insurance Commissioners and as filed with the insurance commissioners of the states in which insurers are licensed to do business constitute health risks for this purpose: comprehensive (hospital and medical), vision, dental, Federal Employees Health Benefit plan, title XVIII Medicare, title XIX Medicaid, and other health.

Under present law, health insurance does not include coverage only for accident, or disability income insurance, or a combination thereof. Health insurance does not include coverage only for a specified disease or illness, nor does health insurance include hospital indemnity or other fixed-indemnity insurance. Health insurance does not include any insurance for long-term care or any

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Medicare supplemental health insurance (as defined in section 1882(g)(1) of the Social Security Act).

For purposes of procedure and administration under the rules of Subtitle F of the IRC, the fee under this provision is treated as an excise tax with respect to which only civil actions for refund under Subtitle F apply. The Secretary may redetermine the amount of a covered entity's fee under present law for any calendar year for which the statute of limitations remains open.

For purposes of IRC section 275, relating to the nondeductibility of specified taxes, the fee is considered to be a nondeductible tax described in IRC section 275(a)(6).

A reporting rule applies under present law. A covered entity is required to report to the Secretary the amount of its net premiums written during any calendar year with respect to health insurance for any United States health risk.

A penalty applies for failure to report, unless it is shown that the failure is due to reasonable cause. The amount of the penalty is \$10,000 plus the lesser of: (1) \$1,000 per day while the failure continues; or (2) the amount of the fee imposed for which the report was required. The penalty is treated as a penalty for purposes of subtitle F of the IRC, must be paid on notice and demand by the Treasury Department and in the same manner as tax, and with respect to which only civil actions for refund under procedures of subtitle F apply. The reported information is not treated as taxpayer information under IRC section 6103.

An accuracy-related penalty applies in the case of any understatement of a covered entity's net premiums written. For this purpose, an understatement is the difference between the amount of net premiums written as reported on the return filed by the covered entity and the amount of net premiums written that should have been reported on the return. The penalty is equal to the amount of the fee that should have been paid in the absence of an understatement over the amount of the fee determined based on the understatement. The accuracy-related penalty is subject to the provisions of subtitle F of the IRC that apply to assessable penalties imposed under Chapter 68.

Present law provides authority for the Secretary to publish guidance necessary to carry out the purposes of the law and to prescribe regulations necessary or appropriate to prevent avoidance of the purposes of the provision, including inappropriate actions taken to qualify as an exempt entity under the provision.

New Federal Law (Uncodified Act Section 4003 Amends Division P, Section 9010 of the Consolidated Appropriations Act, 2016)

The provision suspends the annual fee on health insurance providers for the 2019 calendar year.

Effective Date

The provision shall apply to calendar years beginning after December 31, 2018.

California Law (R&TC sections 13201–13222, 17201, 17202, 17240, 24345 and Section 28 of Article XIII of the California Constitution)

## **Federal Annual Fee on Health Insurance Providers**

California does not conform to the federal annual fee on health insurance providers.

## **Deductibility of the Federal Annual Fee on Health Insurance Providers**

### *Insurance Companies in General*

Insurance companies must be admitted to do business in California. Such insurers are subject to the gross premiums tax that is jointly administered by the California Department of Tax and Fee Administration, State Board of Equalization, California Department of Insurance and the State Controller's Office rather than the tax under the Personal Income Tax Law (PITL) or Corporation Tax Law (CTL) that are administered by the FTB.

Once admitted, those insurance companies pay the gross premiums tax, which is not administered by the FTB. Insurance companies are not subject to tax under the PITL or the CTL.

### *Nonadmitted Insurance Policyholders*

The FTB administers the tax on nonadmitted insurance policyholders. Policyholders who purchase or renew an insurance contract during the calendar quarter from an insurance company that is not authorized to transact business in California must pay a “nonadmitted insurance tax.” The tax is 3 percent on all premiums paid or to be paid to nonadmitted insurers on contracts covering risks located in California, and is imposed on any corporation, partnership, limited liability company, individual, society, association, organization, governmental or quasi-governmental entity, joint-stock company, estate or trust, receiver, trustee, assignee, referee, or any other person acting in a fiduciary capacity.<sup>17</sup>

Policyholders subject to the tax must file a California Form 570, Nonadmitted Insurance Tax Return, with the FTB on or before the first day of the third month following the close of any calendar quarter during which a nonadmitted insurance contract took effect or was renewed.

### *Entities That Are Not Insurance Companies*

Certain entities that are not insurance companies are required to pay the federal annual fee on health insurance providers and are subject to the PITL or the CTL.

California conforms to IRC section 162, under the PITL and the CTL, relating to the deduction of ordinary and necessary trade or business expenses.<sup>18</sup>

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<sup>17</sup> R&TC sections 13201–13222.

<sup>18</sup> R&TC sections 17201, 17202 and 24343.

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California conforms, under the PITL, to IRC section 275, relating to the deductibility of certain taxes,<sup>19</sup> as of the specified date of January 1, 2015.<sup>20</sup> Since for federal purposes the annual fee on health service providers is considered an excise tax under IRC section 275(a)(6), it is not allowed as a deduction under the PITL.

Under the CTL, California has standalone law which allows a deduction for certain taxes and licenses, including federal excise taxes or fees, other than the federal annual fee on branded prescription pharmaceutical manufacturers and importers.<sup>21</sup> As a result, the CTL allows a deduction for the federal annual fee on health insurance providers.

Impact on California Revenue

Not applicable.

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<sup>19</sup> R&TC sections 17201 and 17240.

<sup>20</sup> R&TC sections 17024.5 and 23051.5.

<sup>21</sup> R&TC section 24345 and 24345.5.

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**Division B—Supplemental Appropriations, Tax Relief, and Medicaid Changes  
Relating to Certain Disasters and Further Extension of Continuing Appropriations  
Subdivision 2—Tax Relief and Medicaid Changes Relating to Certain Disasters**

**Title I—California Fires**

<u>Section</u>	<u>Section Title</u>
20101	Definitions

Background

Present law provides tax relief for victims of hurricanes Harvey, Irma and Maria that hit the Gulf region in 2017.<sup>22</sup> These tax relief provisions include special disaster-related rules for use of retirement funds, disaster-related employment relief, enhanced charitable deductions and casualty losses, and allowing the use of the previous year earned income for the earned income tax credit (EITC) and the child tax credit (CTC).

New Federal Law (Uncodified Act section 20101)

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 arising in the California wildfire disaster area on or after January 1, 2017, through January 18, 2018, and which are attributable to California wildfires.

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 Robert T. Stafford Disaster Relief and Emergency Assistance Act<sup>23</sup> 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 on the enactment date, February 9, 2018, for losses arising in the California wildfire disaster area on or after January 1, 2017, through January 18, 2018.

California Law (None)

California does not conform to the uncodified federal act provision.

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<sup>22</sup> Disaster Tax Relief and Airport and Airway Extension Act of 2017, Public Law 115-63, September 29, 2017.

<sup>23</sup> Public Law 100-707.

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Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Title</u>
20102	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);<sup>24</sup> and (2) the loan is required to be repaid within five years,<sup>25</sup> except that a longer repayment period can be used for a principal residence plan loan.<sup>26</sup>

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.<sup>27</sup> The additional tax applies unless the taxpayer qualifies for one of several specific exceptions.<sup>28</sup>

New Federal Law (Uncodified Act section 20102 affecting IRC sections 72, 402, 408, and 3405)

This provision eases a number of rules to allow victims to make qualified wildfire distributions (QWD) from their retirement plans of up to \$100,000, less any prior withdrawals treated as QWDs. QWDs are also an exception to 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 QWD is defined as any distribution from an eligible retirement plan,<sup>29</sup> including individual retirement accounts (IRAs), made on or after October 8, 2017, and before January 1, 2019, to an individual whose principal place of abode on October 8, 2017, through December 31, 2017, is located in the California wildfire disaster area and who has sustained an economic loss by reason of the wildfires.

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<sup>24</sup> IRC section 72(p)(2)(A).

<sup>25</sup> IRC section 72(p)(2)(B)(i).

<sup>26</sup> IRC section 72(p)(2)(B)(ii).

<sup>27</sup> IRC section 72(t)(1).

<sup>28</sup> IRC sections 72(t)(2) and 72(t)(3).

<sup>29</sup> IRC section 402(c)(8)(B).



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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 QWD in an eligible rollover distribution<sup>30</sup> 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 QWD is treated as a distribution<sup>31</sup> that is transferred to an eligible retirement plan in a direct trustee-to-trustee distribution within 60 days of the distribution.

QWDs are not treated as eligible rollover distributions for purposes of the 20-percent withholding requirement.<sup>32</sup>

The provision also allows for the re-contribution of certain retirement plan withdrawals for home purchases or construction, during the period beginning on March 31, 2017, and ending on January 15, 2018, where the home purchase or construction was cancelled on account of California wildfires. A timely re-contribution avoids tax on the plan withdrawal if made during the period beginning on October 8, 2017, and ending on June 30, 2018.

With respect to retirement plan loans, the provision:

- Increases the maximum amount that a participant or beneficiary can borrow from a qualified employer plan,<sup>33</sup> 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 the period beginning on or after October 8, 2017, and ending 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 Dates

This provision is effective as of the date of enactment, February 9, 2018.

### 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 QWDs from and re-contributions to a wildfire victim's retirement plan.<sup>34</sup> Under the PITL, California generally conforms to

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<sup>30</sup> IRC section 402(c)(4).

<sup>31</sup> IRC section 408(d)(3).

<sup>32</sup> IRC section 3405(c)(1)(B).

<sup>33</sup> IRC section 72(p)(2)(A).

<sup>34</sup> 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



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retirement plan loan rules as of the specified date of January 1, 2015,<sup>35</sup> 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.<sup>36</sup> However, because under this provision the federal 20-percent withholding is not applicable to QWDs that are eligible rollover distributions, California withholding does not apply.

California 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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<u>Section</u>	<u>Section Title</u>
20103	Employee Retention Credit for Employers Affected by California Wildfires

### 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 tax credit (WOTC), 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.<sup>37</sup>

### New Federal Law (Uncodified Act section 20103 affecting IRC sections 38 and 51)

The provision creates a new “employee retention credit” for eligible employers affected by California wildfires. Eligible employers are generally defined as employers that conducted an active trade or business in a disaster zone as of the specified date of October 8, 2017, 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 wildfires.

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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).

<sup>35</sup> 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.

<sup>36</sup> Unemployment Insurance Code (UIC) section 13028(c)(3).

<sup>37</sup> IRC section 38(a). Also, IRC section 38(b) contains a list of the component credits of the current year business credit.

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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<sup>38</sup> 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 wildfires, and ending on the date on which such trade or business has resumed significant operations at such principal place of employment.

Qualified wages include 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.

The provision also provides that rules<sup>39</sup> similar to those disallowing the 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.<sup>40</sup>

Effective Dates

The provision is effective for wages paid or incurred after October 8, 2017, and before 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.

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<u>Section</u>	<u>Section Title</u>
20104	Additional Disaster-Related Tax Relief Provisions

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<sup>38</sup> As defined in IRC section 51(c)(1) but without regard to IRC section 3306(b)(2)(B).

<sup>39</sup> IRC section 51(i)(1).

<sup>40</sup> IRC section 52.

## 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.<sup>41</sup> A corporation generally can deduct charitable contributions up to 10 percent of its taxable income.<sup>42</sup> 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.<sup>43</sup> For individuals, charitable contributions are deductible only as an itemized deduction.<sup>44</sup>

### *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.<sup>45</sup> 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.<sup>46</sup> In addition, aggregate net casualty and theft losses are deductible only to the extent they exceed 10 percent of an individual taxpayer's AGI.<sup>47</sup> 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.<sup>48</sup>

### *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.<sup>49</sup> 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<sup>50</sup> for the year.<sup>51</sup>

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<sup>41</sup> IRC section 170(b)(1).

<sup>42</sup> IRC section 170(b)(2).

<sup>43</sup> IRC section 170(d).

<sup>44</sup> Treasury Regulation section 1.170A-1(a).

<sup>45</sup> IRC section 165.

<sup>46</sup> IRC section 165(h)(1).

<sup>47</sup> IRC section 165(h)(2).

<sup>48</sup> IRC section 165(i).

<sup>49</sup> IRC section 32.

<sup>50</sup> IRC section 164(f).

<sup>51</sup> IRC section 32(c)(2)(A).

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Individuals can claim a \$1,000 CTC for each qualifying child the taxpayer can claim as a dependent.<sup>52</sup> The child must be under 17 and a U.S. citizen or resident alien.<sup>53</sup> 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.<sup>54</sup> 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.<sup>55</sup>

New Federal Law (Uncodified Act section 20104 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 wildfire 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 October 8, 2017, and ending on December 31, 2018, 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),<sup>56</sup> for relief efforts in the California wildfire 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.

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<sup>52</sup> IRC section 24.

<sup>53</sup> IRC section 24(c).

<sup>54</sup> IRC section 24(b).

<sup>55</sup> IRC section 24(d).

<sup>56</sup> IRC section 170(b)(1)(A).

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The law which generally disallows the standard deduction for alternative minimum tax (AMT) 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 any portion of the applicable period, from October 8, 2017, through December 31, 2017, 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 period. If the election is made, it applies for purposes of both the refundable EITC and CTC.

A qualified individual is one whose principal place of abode during the applicable period was located in the California wildfire disaster zone and the individual was displaced from their principal place of abode by reason of the California wildfires. In the case of joint filers, the above election may apply if either spouse is a qualified individual.

Effective Dates

The provision is effective for charitable contributions made and casualty losses arising during the period October 8, 2017, through December 31, 2017. It is also effective for determining earned income for taxable years that include the period October 8, 2017, through December 31, 2017.

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,<sup>57</sup> and as a result, does not conform to the wildfire 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.<sup>58</sup> There are no similar provisions for wildfire relief suspension of AGI limitations, exclusion of carryover period limitations to other contributions, and eased rules governing the treatment of excess contributions.

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<sup>57</sup> 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.

<sup>58</sup> R&TC sections 24357 – 24359.1.

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*Casualty Losses*

California conforms by reference to IRC section 165, relating to losses, as of the specified date of January 1, 2015.<sup>59</sup> 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.

California does not conform to the federal standard deduction amounts, but instead has its own standard-deduction provision.<sup>60</sup> Thus, the California standard deduction is unaffected by qualified disaster-related personal casualty losses.

*Special Rule for Determining Earned Income for the EITC and CTC*

For purposes of the California EITC, the federal definition of “earned income” is modified to include wages, salaries, tips, and other employee compensation, includable in federal AGI, but only if such amounts are subject to California withholding.<sup>61</sup>

For taxable years beginning on or after January 1, 2017, the California EITC was modified to include, in the definition of earned income, net earnings from self-employment, consistent with federal law.

Thus, for purposes of determining the EITC or CTC, 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 the wildfire zone and area.

Impact on California Revenue

Not applicable.

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**Title II—Tax Relief for Hurricanes Harvey, Irma, and Maria**

<u>Section</u>	<u>Section Title</u>
20201	Tax Relief for Hurricanes Harvey, Irma, and Maria

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<sup>59</sup> R&TC section 17024.5.

<sup>60</sup> R&TC section 17073.5.

<sup>61</sup> Pursuant to Division 6 (commencing with section 13000) of the Unemployment Insurance Code.

## Background

### *Hurricane Disaster Areas and Zones*

Section 501 of the Disaster Tax Relief and Airport and Airway Extension Act of 2017<sup>62</sup> (Act), in an 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 Robert T. Stafford Disaster Relief and Emergency Assistance Act<sup>63</sup> 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 before September 21, 2017.

### *Disaster-Related Employment Relief*

The 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.<sup>64</sup>

Section 503 of the Act, in an uncodified provision, created 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.

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<sup>62</sup> Public Law 115-63, enacted September 29, 2017.

<sup>63</sup> Public Law 100-707.

<sup>64</sup> IRC section 38(a). Also, IRC section 38(b) contains a list of the component credits of the current year business credit.



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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<sup>65</sup> 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.

The Act also provides that rules<sup>66</sup> similar to those disallowing the 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.<sup>67</sup>

New Federal Law (Uncodified Act section 20201 affecting IRC sections 38 and 51)

For purposes of defining a disaster area under the Act, the provision extends the date by which the President must declare a major disaster from before September 21, 2017, to before October 17, 2017.

In addition, the provision specifies that no deduction shall be allowed for that portion of the wages or salaries paid or incurred for the taxable year which is equal to the amount of the employee retention credit.<sup>68</sup> The rules similar to those that apportion credit amounts among commonly-controlled businesses shall apply to the allocation of wage amounts used to determine the credit.<sup>69</sup>

Effective Dates

The provision is effective as if included in the provisions of Title V of the Disaster Tax Relief and Airport and Airway Extension Act of 2017.

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<sup>65</sup> As defined in IRC section 51(c)(1) but without regard to IRC section 3306(b)(2)(B).

<sup>66</sup> IRC section 51(i)(1).

<sup>67</sup> IRC section 52.

<sup>68</sup> IRC section 280C(a).

<sup>69</sup> IRC section 52(a) and (b).



California Law (None)

California does not conform to the uncodified federal act provisions relating to the hurricane disaster areas, the federal employee retention credit, or the existing federal GBC provisions.

Impact on California Revenue

Baseline.

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**Division D—Revenue Measures**  
**Title I—Extension of Expiring Provisions**  
**Subtitle A—Tax Relief for Families and Individuals**

<u>Section</u>	<u>Section Title</u>
40201	Extension and Modification of Exclusion from Gross Income of Discharge of Qualified Principal Indebtedness

Background

**In General**

Gross income includes income that is realized by a debtor from the discharge of indebtedness, subject to certain exceptions for debtors in Title 11 bankruptcy cases, insolvent debtors, certain student loans, certain farm indebtedness, and certain real property business indebtedness.<sup>70</sup> In cases involving discharges of indebtedness that are excluded from gross income under the exceptions to the general rule, taxpayers generally reduce certain tax attributes, including basis in property, by the amount of the discharge of indebtedness.

The amount of discharge of indebtedness excluded from income by an insolvent debtor not in a Title 11 bankruptcy case cannot exceed the amount by which the debtor is insolvent. In the case of a discharge in bankruptcy or where the debtor is insolvent, any reduction in basis may not exceed the excess of the aggregate bases of properties held by the taxpayer immediately after the discharge over the aggregate of the liabilities of the taxpayer immediately after the discharge.<sup>71</sup>

For all taxpayers, the amount of discharge of indebtedness generally is equal to the difference between the adjusted issue price of the debt being cancelled and the amount used to satisfy the debt. These rules generally apply to the exchange of an old obligation for

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<sup>70</sup> IRC sections 61(a)(12) and 108. A debt cancellation which constitutes a gift or bequest is not treated as income to the donee debtor. IRC section 102.

<sup>71</sup> IRC section 1017.

a new obligation, including a modification of indebtedness that is treated as an exchange (a debt-for-debt exchange).

### **Qualified Principal Residence Indebtedness**

An exclusion from gross income is provided for any discharge of indebtedness income by reason of a discharge (in whole or in part) of qualified principal residence indebtedness. Qualified principal residence indebtedness means acquisition indebtedness (within the meaning of IRC section 163(h)(3)(B), except that the dollar limitation is \$2 million) with respect to the taxpayer's principal residence. Acquisition indebtedness with respect to a principal residence generally means indebtedness which is incurred in the acquisition, construction, or substantial improvement of the principal residence of the individual and is secured by the residence. It also includes refinancing of such indebtedness to the extent the amount of the indebtedness resulting from such refinancing does not exceed the amount of the refinanced indebtedness. For these purposes, the term "principal residence" has the same meaning as under IRC section 121.

If, immediately before the discharge, only a portion of a discharged indebtedness is qualified principal residence indebtedness, the exclusion applies only to so much of the amount discharged as exceeds the portion of the debt which is not qualified principal residence indebtedness. Thus, assume that a principal residence is secured by an indebtedness of \$1 million, of which \$800,000 is qualified principal residence indebtedness. If the residence is sold for \$700,000 and \$300,000 debt is discharged, then only \$100,000 of the amount discharged may be excluded from gross income under the qualified principal residence indebtedness exclusion. The basis of the individual's principal residence is reduced by the amount excluded from income.

The qualified principal residence indebtedness exclusion does not apply to a taxpayer in a Title 11 case; instead the general exclusion rules apply. In the case of an insolvent taxpayer not in a Title 11 case, the qualified principal residence indebtedness exclusion applies unless the taxpayer elects to have the general exclusion rules apply instead.

The exclusion does not apply to the discharge of a loan if the discharge is on account of services performed for the lender or any other factor not directly related to a decline in the value of the residence or to the financial condition of the taxpayer.

The exclusion for qualified principal residence indebtedness is effective for discharges of indebtedness before January 1, 2017.

Current law also provides for an exclusion from gross income in the case of those taxpayers whose qualified principal residence indebtedness was discharged on or after January 1, 2017, if the discharge was pursuant to a binding written agreement entered into prior to January 1, 2017.

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New Federal Law (IRC section 108)

The provision extends for one additional year, before January 1, 2018, the exclusion from gross income for discharges of qualified principal residence indebtedness. The provision also provides for an exclusion from gross income in the case of those taxpayers whose qualified principal residence indebtedness was discharged on or after January 1, 2018, if the discharge was pursuant to a binding written agreement entered into prior to January 1, 2018.

Effective Date

The provision applies to discharges of indebtedness after December 31, 2016.

California Law (R&TC sections 17071, 17131, and 17144.5)

California generally conforms to the federal definition of gross income, including income from the discharge of indebtedness,<sup>72</sup> and formerly conformed to the federal rules for the exclusion of discharge-of-indebtedness income by reason of a discharge of qualified principal residence indebtedness (i.e., mortgage forgiveness debt relief),<sup>73</sup> as of the specified date of January 1, 2015,<sup>74</sup> with the modifications described below:

- A. The exclusion does not apply to discharges occurring after 2013.
  - The California exclusion applies to discharges occurring on or after January 1, 2007, and before January 1, 2014.
  - The federal exclusion generally applies to discharges occurring on or after January 1, 2007, and before January 1, 2018.<sup>75</sup>
- B. The maximum amount of qualified principal residence indebtedness (i.e., the amount of principal residence indebtedness eligible for the exclusion) is reduced.
  - The California maximum amount of qualified principal residence indebtedness is \$800,000 (\$400,000 in the case of a married/registered domestic partner (RDP) individual filing a separate return).
  - The federal maximum amount of qualified principal residence indebtedness is \$2,000,000 (\$1,000,000 in the case of a married individual filing a separate return).
- C. The total amount that may be excluded from gross income is limited.
  - For discharges occurring in 2007 or 2008, California limits the total amount that may be excluded from gross income to \$250,000 (\$125,000 in the case of a married/RDP individual filing a separate return).

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<sup>72</sup> R&TC sections 17071 and 17131.

<sup>73</sup> R&TC section 17144.5.

<sup>74</sup> R&TC section 17024.5.

<sup>75</sup> Federal law also provides for an exclusion from gross income in the case of those taxpayers whose qualified principal residence indebtedness was discharged on or after January 1, 2018, if the discharge was pursuant to a binding written agreement entered into prior to January 1, 2018.

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- For discharges occurring in 2009, 2010, 2011, 2012, or 2013, California limits the total amount that may be excluded from gross income to \$500,000 (\$250,000 in the case of a married/RDP individual filing a separate return).
- There is no comparable federal limitation in any year.

**D. Interest and penalties are not imposed with respect to 2007, 2009, or 2013 discharges.**

- California prohibits the imposition of any interest or penalties with respect to discharges of qualified principal residence that occurred during the 2007, 2009, or 2013 taxable years.
- There is no comparable federal prohibition.

Impact on California Revenue

Estimated Conformity Revenue Impact of Extension and Modification of Exclusion from Gross Income of Discharge of Qualified Principal Indebtedness For Taxable Years Beginning On or After January 1, 2019 Enactment Assumed After June 30, 2019			
2018-19	2019-20	2020-21	2021-22
- \$40,000,000	- \$17,000,000	\$0	\$0

<u>Section</u>	<u>Section Title</u>
40202	Extension of Mortgage Insurance Premiums Treated as Qualified Residence Interest

Background

**In General**

Present law provides that qualified residence interest is deductible notwithstanding the general rule that personal interest is nondeductible.<sup>76</sup>

**Acquisition Indebtedness and Home Equity Indebtedness**

Qualified residence interest is interest on acquisition indebtedness and home equity indebtedness with respect to a principal and a second residence of the taxpayer. The maximum amount of home equity indebtedness is \$100,000. The maximum amount of

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<sup>76</sup> IRC section 163(h).

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acquisition indebtedness is \$1 million. Acquisition indebtedness means debt that is incurred in acquiring, constructing, or substantially improving a qualified residence of the taxpayer, and that is secured by the residence. Home equity indebtedness is debt (other than acquisition indebtedness) that is secured by the taxpayer's principal or second residence, to the extent the aggregate amount of such debt does not exceed the difference between the total acquisition indebtedness with respect to the residence, and the fair market value of the residence.

### **Qualified Mortgage Insurance**

Certain premiums paid or accrued for qualified mortgage insurance by a taxpayer during the taxable year in connection with acquisition indebtedness on a qualified residence of the taxpayer are treated as interest that is qualified residence interest and thus deductible. The amount allowable as a deduction is phased out ratably by 10 percent for each \$1,000 (or fraction thereof) by which the taxpayer's AGI exceeds \$100,000 (\$50,000 and \$50,000, respectively, in the case of a married individual filing a separate return). Thus, the deduction is not allowed if the taxpayer's AGI exceeds \$109,000 (\$54,000 in the case of married individual filing a separate return).

For this purpose, qualified mortgage insurance means mortgage insurance provided by the Department of Veterans Affairs, the Federal Housing Administration, or the Rural Housing Service, and private mortgage insurance (defined in section two of the Homeowners Protection Act of 1998 as in effect on December 18, 2015).

Amounts paid for qualified mortgage insurance that are properly allocable to periods after the close of the taxable year are treated as paid in the period to which they are allocated. No deduction is allowed for the unamortized balance if the mortgage is paid before its term (except in the case of qualified mortgage insurance provided by the Department of Veterans Affairs or Rural Housing Service).

The provision does not apply with respect to any mortgage insurance contract issued before January 1, 2007. The provision terminates for any amount paid or accrued after December 31, 2016, or properly allocable to any period after that date.

Reporting rules apply under the provision.

### New Federal Law (IRC section 163)

The provision extends the deduction for private mortgage insurance premiums for one year (with respect to contracts entered into after December 31, 2016). Thus, the provision applies to amounts paid or accrued in 2017 (and not properly allocable to any period after 2017).

### Effective Date

The provision applies to amounts paid or accrued after December 31, 2016.

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California Law (R&TC section 17225)

The PITL specifically does not conform to the federal deduction for private mortgage insurance premiums. As a result, private mortgage insurance premiums are not deductible under California law, and taxpayers who deduct such premiums on their federal tax returns report the amount deducted for federal purposes as a California adjustment on Schedule CA (540/540NR).

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
40203	Extension of Above-the-Line Deduction for Qualified Tuition and Related Expenses

Background

An individual is allowed a deduction for qualified tuition and related expenses for higher education paid by the individual during the taxable year.<sup>77</sup> The deduction is allowed in computing AGI. The term qualified tuition and related expenses is defined in the same manner as for the Hope and Lifetime Learning credits, and includes tuition and fees required for the enrollment or attendance of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer with respect to whom the taxpayer may claim a personal exemption, at an eligible institution of higher education for courses of instruction of such individual at such institution.<sup>78</sup> The expenses must be in connection with enrollment at an institution of higher education during the taxable year, or with an academic period beginning during the taxable year or during the first three months of the next taxable year. The deduction is not available for tuition and related expenses paid for elementary or secondary education.

The maximum deduction is \$4,000 for an individual whose AGI for the taxable year does not exceed \$65,000 (\$130,000 in the case of a joint return), or \$2,000 for other individuals whose AGI does not exceed \$80,000 (\$160,000 in the case of a joint return). No deduction is allowed for an individual whose AGI exceeds the relevant AGI limitations, for a married individual who does not file a joint return, or for an individual with respect to whom a personal exemption deduction may be claimed by another taxpayer for the taxable year. The deduction is not available for taxable years beginning after December 31, 2016.

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<sup>77</sup> IRC section 222.

<sup>78</sup> The deduction generally is not available for expenses with respect to a course or education involving sports, games, or hobbies, and is not available for student activity fees, athletic fees, insurance expenses, or other expenses unrelated to an individual's academic course of instruction.

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The amount of qualified tuition and related expenses must be reduced by certain scholarships, educational assistance allowances, and other amounts paid for the benefit of such individual,<sup>79</sup> and by the amount of such expenses taken into account for purposes of determining any exclusion from gross income of: (1) income from certain U.S. savings bonds used to pay higher education tuition and fees; and (2) income from a Coverdell education savings account.<sup>80</sup>

Additionally, such expenses must be reduced by the earnings portion (but not the return of principal) of distributions from a qualified tuition program if an exclusion from income is claimed under IRC section 529 with respect to expenses eligible for the qualified tuition deduction. No deduction is allowed for any expense for which a deduction is otherwise allowed or with respect to an individual for whom a Hope or Lifetime Learning credit is elected for such taxable year.

New Federal Law (IRC section 222)

The provision extends the qualified tuition deduction for two years, through 2017.

Effective Date

The provision applies to taxable years beginning after December 31, 2016.

California Law (R&TC section 17204.7)

California's PITL specifically does not conform to the federal qualified tuition deduction. As a result, California does not allow a deduction for qualified tuition and related expenses, and taxpayers who deduct such expenses on their federal tax returns report the amount deducted for federal purposes as a California adjustment on Schedule CA (540/540NR).

Impact on California Revenue

Not applicable.

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**Subtitle B—Incentives for Growth, Jobs, Investment, and Innovation**

<u>Section</u>	<u>Section Title</u>
40301	Extension of Indian Employment Tax Credit

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<sup>79</sup> IRC sections 222(d)(1) and 25A(g)(2).

<sup>80</sup> IRC section 222(c). These reductions are the same as those that apply to the Hope and Lifetime Learning credits.

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Background

In general, a credit against income tax liability is allowed to employers for the first \$20,000 of qualified wages and qualified employee health insurance costs paid or incurred by the employer with respect to certain employees.<sup>81</sup> The credit is equal to 20 percent of the excess of eligible employee qualified wages and health insurance costs during the current year over the amount of such wages and costs incurred by the employer during 1993. The credit is an incremental credit, such that an employer's current-year qualified wages and qualified employee health insurance costs (up to \$20,000 per employee) are eligible for the credit only to the extent that the sum of such costs exceeds the sum of comparable costs paid during 1993. No deduction is allowed for the portion of the wages equal to the amount of the credit.

Qualified wages means wages paid or incurred by an employer for services performed by a qualified employee. A qualified employee means any employee who is an enrolled member of an Indian tribe or the spouse of an enrolled member of an Indian tribe, who performs substantially all of the services within an Indian reservation, and whose principal place of abode while performing such services is on or near the reservation in which the services are performed.

An "Indian reservation" is a reservation as defined in section 3(d) of the Indian Financing Act of 1974<sup>82</sup> or section 4(10) of the Indian Child Welfare Act of 1978.<sup>83</sup> For purposes of the preceding sentence, section 3(d) is applied by treating "former Indian reservations in Oklahoma" as including only lands that are (1) within the jurisdictional area of an Oklahoma Indian tribe as determined by the Secretary of the Interior, and (2) recognized by such Secretary as an area eligible for trust land status under 25 C.F.R. Part 151 (as in effect on August 5, 1997).

An employee is not treated as a qualified employee for any taxable year of the employer if the total amount of wages paid or incurred by the employer with respect to such employee during the taxable year exceeds an amount determined at an annual rate of \$30,000 (which after adjustment for inflation is \$45,000 for 2017).<sup>84</sup> In addition, an employee will not be treated as a qualified employee under certain specific circumstances, such as where the employee is related to the employer (in the case of an individual employer) or to one of the employer's shareholders, partners, or grantors. Similarly, an employee will not be treated as a qualified employee where the employee has more than a five percent ownership interest in the employer. Finally, an employee will not be considered a qualified employee to the extent the employee's services relate to gaming activities or are performed in a building housing such activities.

The wage credit is available for wages paid or incurred in taxable years beginning on or before December 31, 2016.

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<sup>81</sup> IRC section 45A.

<sup>82</sup> Public Law 93-262.

<sup>83</sup> Public Law 95-608.

<sup>84</sup> See Instructions for Form 8845, Indian Employment Credit (2014).



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New Federal Law (IRC section 45A)

The provision extends for one year the present-law Indian employment credit (through taxable years beginning on or before December 31, 2017).

Effective Date

The provision is effective for taxable years beginning after December 31, 2016.

California Law (None)

California does not conform to the Indian Employment Tax Credit.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
40302	Extension and Modification of Railroad Track Maintenance Credit

Background

Present law provides a 50-percent business tax credit for qualified railroad track maintenance expenditures paid or incurred by an eligible taxpayer during taxable years beginning before January 1, 2017.<sup>85</sup> The credit is limited to the product of \$3,500 times the number of miles of railroad track (1) owned or leased by an eligible taxpayer as of the close of its taxable year, and (2) assigned to the eligible taxpayer by a Class II or Class III railroad that owns or leases such track at the close of the taxable year.<sup>86</sup> Each mile of railroad track may be taken into account only once, either by the owner of such mile or by the owner's assignee, in computing the per-mile limitation. The credit also may reduce a taxpayer's tax liability below its tentative minimum tax.<sup>87</sup> Basis of the railroad track must be reduced (but not below zero) by an amount equal to 100 percent of the taxpayer's qualified railroad track maintenance tax credit determined for the taxable year.<sup>88</sup>

Qualified railroad track maintenance expenditures are defined as gross expenditures (whether or not otherwise chargeable to capital account) for maintaining railroad track (including roadbed, bridges, and related track structures) owned or leased as of

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<sup>85</sup> IRC section 45G(a) and (f).

<sup>86</sup> IRC section 45G(b)(1).

<sup>87</sup> IRC section 38(c)(4).

<sup>88</sup> IRC section 45G(e)(3).

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January 1, 2005, by a Class II or Class III railroad (determined without regard to any consideration for such expenditure given by the Class II or Class III railroad which made the assignment of such track).<sup>89</sup>

An eligible taxpayer means any Class II or Class III railroad, and any person who transports property using the rail facilities of a Class II or Class III railroad or who furnishes railroad-related property or services to a Class II or Class III railroad, but only with respect to miles of railroad track assigned to such person by such railroad under the provision.<sup>90</sup>

The terms Class II or Class III railroad have the meanings given by the Surface Transportation Board.<sup>91</sup>

Current law also provides that qualified railroad track maintenance expenditures paid or incurred in taxable years beginning after December 31, 2016, are defined as gross expenditures (whether or not otherwise chargeable to capital account) for maintaining railroad track (including roadbed, bridges, and related track structures) owned or leased as of January 1, 2015, by a Class II or Class III railroad (determined without regard to any consideration for such expenditure given by the Class II or Class III railroad which made the assignment of such track).

New Federal Law (IRC section 45G)

The provision extends the present-law credit for one year, for qualified railroad track maintenance expenditures paid or incurred in taxable years beginning after December 31, 2016, and before January 1, 2018.

The provision also specifies that any assignment of railroad track, including related expenditures paid or incurred, for taxable years ending after January 1, 2017, and before January 1, 2018, shall be treated as effective as of the close of such taxable year if made pursuant to a written agreement entered into no later than 90 days after February 9, 2018, the date of enactment.

Effective Date

The provision is generally effective for expenditures paid or incurred in taxable years beginning after December 31, 2016. Assignments of railroad track, including related expenditures paid or incurred, for taxable years ending after January 1, 2017, and before January 1, 2018, shall be treated as effective as of the close of such taxable year if made pursuant to a written agreement entered into no later than 90 days after February 9, 2018.

California Law (None)

California does not conform to the railroad track maintenance credit.

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<sup>89</sup> IRC section 45G(d).

<sup>90</sup> IRC section 45G(c).

<sup>91</sup> IRC section 45G(e)(1).

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Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
40303	Extension of Mine Rescue Team Training Credit

Background

An eligible employer may claim a GBC against income tax with respect to each qualified mine rescue team employee equal to the lesser of: (1) 20 percent of the amount paid or incurred by the taxpayer during the taxable year with respect to the training program costs of the qualified mine rescue team employee (including the wages of the employee while attending the program); or (2) \$10,000.<sup>92</sup> A qualified mine rescue team employee is any full-time employee of the taxpayer who is a miner eligible for more than six months of a taxable year to serve as a mine rescue team member by virtue of either having completed the initial 20 hour course of instruction prescribed by the Mine Safety and Health Administration's Office of Educational Policy and Development, or receiving at least 40 hours of refresher training in such instruction.<sup>93</sup>

An eligible employer is any taxpayer which employs individuals as miners in underground mines in the United States.<sup>94</sup> The term "wages" has the meaning given to such term by IRC section 3306(b)<sup>95</sup> (determined without regard to any dollar limitation contained in that section).<sup>96</sup>

No deduction is allowed for the portion of the expenses otherwise deductible that is equal to the amount of the credit.<sup>97</sup> The credit does not apply to taxable years beginning after December 31, 2016.<sup>98</sup> Additionally, the credit is not allowable for purposes of computing the AMT.<sup>99</sup>

New Federal Law (IRC section 45N)

The provision extends the credit for one year through taxable years beginning on or before December 31, 2017.

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<sup>92</sup> IRC section 45N(a).

<sup>93</sup> IRC section 45N(b).

<sup>94</sup> IRC section 45N(c).

<sup>95</sup> IRC section 3306(b) defines wages for purposes of federal unemployment tax.

<sup>96</sup> IRC section 45N(d).

<sup>97</sup> IRC section 280C(e).

<sup>98</sup> IRC section 45N(e).

<sup>99</sup> IRC section 38(c).

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Effective Date

The provision is effective for taxable years beginning after December 31, 2016.

California Law (None)

California does not conform to the mine rescue team training credit.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
40304	Extension of Classification of Certain Race Horses as 3-Year Property

Background

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization.<sup>100</sup> Tangible property generally is depreciated under the modified accelerated cost recovery system (MACRS), which determines depreciation by applying specific recovery periods,<sup>101</sup> placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.<sup>102</sup> In particular, the statute assigns a three-year recovery period for any race horse (1) that is placed in service after December 31, 2008, and before January 1, 2017,<sup>103</sup> and (2) that is placed in service after December 31, 2016, and that is more than two years old at such time it is placed in service by the purchaser.<sup>104</sup> A seven-year recovery period is assigned to any race horse that is placed in service after December 31, 2016, and that is two years old or younger at the time it is placed in service.<sup>105</sup>

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<sup>100</sup> See IRC sections 263(a) and 167.

<sup>101</sup> 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.

<sup>102</sup> IRC section 168.

<sup>103</sup> IRC section 168(e)(3)(A)(i)(I), as in effect after amendment by the Food, Conservation and Energy Act of 2008, Public Law 110-246, section 15344(b).

<sup>104</sup> IRC section 168(e)(3)(A)(i)(II). A horse is more than two years old after the day that is 24 months after its actual birth date. Revenue Procedure 87-56, 1987-2 C.B. 674, as clarified and modified by Revenue Procedure 88-22, 1988-1 C.B. 785.

<sup>105</sup> Revenue Procedure 87-56, 1987-2 C.B. 674, asset class 01.225.

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New Federal Law (IRC section 168)

The provision extends the present-law three-year recovery period for race horses for one year to apply to any race horse (regardless of age when placed in service) which is placed in service before January 1, 2018. Subsequently, the three-year recovery period will only apply for race horses that are more than two years old when placed in service by the purchaser after December 31, 2017.

Effective Date

The provision applies to property placed in service after December 31, 2016.

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

Under the PITL, for taxable years beginning on or after January 1, 2015, California law, as it relates to MACRS in general, conforms to IRC section 168 as of a specified date of January 1, 2015,<sup>106</sup> with modifications.<sup>107</sup>

For taxable years beginning on or after January 1, 2010, the PITL conformed to the special recovery period enacted by the Heartland Habitat, Harvest, and Horticulture Act of 2008, that provided that any race horse that was placed in service before January 1, 2014, was assigned a three-year recovery period. The PITL does not conform to the two-year extension of the special recovery period for racehorses that was enacted in the Consolidated Appropriations Act, 2016,<sup>108</sup> and does not conform to this provision's one-year extension; instead, for race horses placed in service after December 31, 2013, a seven-year recovery period is assigned to any race horse that is two years old or younger at the time it is placed in service, and a three-year recovery period is assigned to any race horse that is more than two years old at the time it is placed in service.

Under the CTL, California does not conform to federal MACRS depreciation. Instead, the CTL is generally in substantial conformity to the pre-1981 federal asset depreciation range (ADR) rules, which generally allow property to be depreciated based on its useful life.<sup>109</sup>

Impact on California Revenue

Not applicable.

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<sup>106</sup> R&TC section 17201 conforms to IRC section 168 as of the specified date of January 1, 2015, except as otherwise provided.

<sup>107</sup> R&TC section 17250.

<sup>108</sup> Section 165 of Public Law 114-113, Division Q, which provided a two-year extension that applied to race horses placed in service after December 31, 2014, and before January 1, 2017.

<sup>109</sup> R&TC sections 24349-24355.4.

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<u>Section</u>	<u>Section Title</u>
40305	Extension of 7-Year Recovery Period for Motorsports Entertainment Complexes

Background

A taxpayer generally must capitalize the cost of property used in a trade or business and recover such cost over time through annual deductions for depreciation or amortization.<sup>110</sup> Tangible property generally is depreciated under MACRS, which determines depreciation by applying specific recovery periods,<sup>111</sup> placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.<sup>112</sup> The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years.<sup>113</sup> Nonresidential real property is 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.<sup>114</sup> 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.<sup>115</sup> Land improvements (such as roads and fences) are recovered using the 150-percent declining balance method and a recovery period of 15 years.<sup>116</sup>

An exception exists for the theme and amusement park industry, whose assets are assigned a recovery period of seven years.<sup>117</sup> Additionally, a motorsports entertainment complex placed in service on or before December 31, 2016, is assigned a recovery period of seven years.<sup>118</sup> For these purposes, a motorsports entertainment complex means a racing track facility which is permanently situated on land and which during the 36-month period

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<sup>110</sup> See IRC sections 263(a) and 167.

<sup>111</sup> 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.

<sup>112</sup> IRC section 168.

<sup>113</sup> IRC section 168(b)(3)(A) and (c).

<sup>114</sup> IRC section 168(d)(2)(A) and (d)(4)(B).

<sup>115</sup> IRC section 168(d)(1) and (d)(4)(A). 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, which 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).

<sup>116</sup> IRC section 168(b)(2)(A) and asset class 00.3 of Revenue Procedure 87-56, 1987-2 C.B. 674. Under the 150-percent declining balance method, the depreciation rate is determined by dividing 150 percent by the appropriate recovery period, 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 will yield a larger depreciation allowance. IRC section 168(b)(2) and (b)(1)(B).

<sup>117</sup> Asset class 80.0 of Revenue Procedure 87-56, 1987-2 C.B. 674.

<sup>118</sup> IRC section 168(e)(3)(C)(ii).

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following its placed-in-service date hosts a racing event.<sup>119</sup> The term motorsports entertainment complex also includes ancillary facilities, land improvements (e.g., parking lots, sidewalks, fences), support facilities (e.g., food and beverage retailing, souvenir vending), and appurtenances associated with such facilities (e.g., ticket booths, grandstands).

New Federal Law (IRC section 168)

The provision extends the present-law seven-year recovery period for motorsports entertainment complexes for one year to apply to property placed in service on or before December 31, 2017.

Effective Date

The provision is effective for property placed in service after December 31, 2016.

California Law (R&TC sections 17201, 17250, and 24349-24355.4)

This provision is not applicable under California law.

The PITL conforms to MACRS, with modifications. Regarding the recovery period for motorsports entertainment complexes, the PITL conformed to the seven-year recovery period for property placed in service on or after January 1, 2005, and before December 31, 2007,<sup>120</sup> but specifically does not conform to the seven-year recovery period for property placed in service on or after January 1, 2008.<sup>121</sup>

The CTL does not adopt MACRS. Instead, the CTL is generally in substantial conformity to the pre-1981 federal ADR rules that generally allow property to be depreciated based on its useful life.<sup>122</sup>

The CTL temporarily adopted the seven-year recovery period for motorsports entertainment complexes, for property placed in service on or after January 1, 2005, and before December 31, 2007.<sup>123</sup> The seven-year recovery period is not allowed for property placed in service on or after January 1, 2008.

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<sup>119</sup> IRC section 168(i)(15).

<sup>120</sup> For taxable years beginning on or after January 1, 2005, and before January 1, 2010, the PITL conformed to the IRC section 168(i)(15) seven-year recovery period under RT&C section 17250, as of the specified date of January 1, 2005; thus, California conformed to the December 31, 2007, termination date contained in IRC section 168(i)(15) that applied as of January 1, 2005.

<sup>121</sup> R&TC section 17250(a)(11).

<sup>122</sup> R&TC sections 24349-24355.4.

<sup>123</sup> Former R&TC section 24355.3, as added by Chapter 691 of the Statutes of 2005, allowed the seven-year recovery period under the CTL for the same period that was allowed under the PITL, for property placed in service on or after January 1, 2005, and before December 31, 2007. Former R&TC section 24355.3 was repealed by Section 68 of Chapter 14 of the Statutes of 2010.



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Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
40306	Extension and Modification of Accelerated Depreciation for Business Property on an Indian Reservation

Background

With respect to certain property used in connection with the conduct of a trade or business within an Indian reservation, depreciation deductions under IRC section 168(j) are determined using the following recovery periods:

3-year property .....	2 years
5-year property .....	3 years
7-year property .....	4 years
10-year property .....	6 years
15-year property .....	9 years
20-year property .....	12 years
Nonresidential real property .....	22 years <sup>124</sup>

“Qualified Indian reservation property” eligible for accelerated depreciation includes property described in the table above which is: (1) used by the taxpayer predominantly in the active conduct of a trade or business within an Indian reservation; (2) not used or located outside the reservation on a regular basis; (3) not acquired (directly or indirectly) by the taxpayer from a person who is related to the taxpayer;<sup>125</sup> and (4) is not property placed in service for purposes of conducting gaming activities.<sup>126</sup> Certain “qualified infrastructure property” may be eligible for the accelerated depreciation even if located outside an Indian reservation, provided that the purpose of such property is to connect with qualified infrastructure property located within the reservation (e.g., roads, power lines, water systems, railroad spurs, and communications facilities).<sup>127</sup>

An “Indian reservation” means a reservation as defined in section 3(d) of the Indian Financing Act of 1974 (25 U.S.C. 1452(d))<sup>128</sup> or section 4(10) of the Indian Child Welfare Act of 1978 (25 U.S.C. 1903(10)).<sup>129</sup> For purposes of the preceding sentence, section 3(d) is applied by treating “former Indian reservations in Oklahoma” as including only lands that are

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<sup>124</sup> IRC section 168(j)(2) does not provide shorter recovery periods for water utility property, residential rental property, or railroad grading and tunnel bores.

<sup>125</sup> For these purposes, the term “related persons” is defined in IRC section 465(b)(3)(C).

<sup>126</sup> IRC section 168(j)(4)(A).

<sup>127</sup> IRC section 168(j)(4)(C).

<sup>128</sup> Public Law 93-262.

<sup>129</sup> Public Law 95-608.

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(1) within the jurisdictional area of an Oklahoma Indian tribe as determined by the Secretary of the Interior, and (2) recognized by such Secretary as an area eligible for trust land status under 25 C.F.R. Part 151 (as in effect on August 5, 1997).<sup>130</sup>

The depreciation deduction allowed for regular tax purposes is also allowed for purposes of the AMT.<sup>131</sup> The accelerated depreciation for qualified Indian reservation property is available with respect to property placed in service on or before December 31, 2016.<sup>132</sup>

Current law also provides that a taxpayer may annually make an irrevocable election out of IRC section 168(j) on a class-by-class basis for qualified Indian reservation property placed in service in taxable years beginning after December 31, 2015.

New Federal Law (IRC section 168)

The provision extends for one year the present-law accelerated depreciation for qualified Indian reservation property to apply to property placed in service on or before December 31, 2017.

Effective Date

The provision is generally effective for property placed in service after December 31, 2016.

California Law (R&TC sections 17250 and 24349-24355.4)

This provision is not applicable under California law.

The PITL generally conforms to MACRS, but specifically does not conform to accelerated depreciation for business property on an Indian Reservation.<sup>133</sup>

The CTL does not adopt MACRS. The CTL is generally in substantial conformity to the pre-1981 federal ADR rules, which generally allow property to be depreciated based on its useful life.<sup>134</sup>

Impact on California Revenue

Not applicable.

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<sup>130</sup> IRC section 168(j)(6).

<sup>131</sup> IRC section 168(j)(3).

<sup>132</sup> IRC section 168(j)(8).

<sup>133</sup> R&TC section 17250(a)(3).

<sup>134</sup> R&TC sections 24349-24355.4.

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<u>Section</u>	<u>Section Title</u>
40307	Extension of Election to Expense Mine Safety Equipment

Background

A taxpayer may elect to treat 50 percent of the cost of any qualified advanced mine safety equipment property as an expense in the taxable year in which the equipment is placed in service.<sup>135</sup> “Qualified advanced mine safety equipment property” means any advanced mine safety equipment property for use in any underground mine located in the United States the original use of which commences with the taxpayer and which is placed in service after December 20, 2006, and before January 1, 2017.<sup>136</sup>

Advanced mine safety equipment property means any of the following: (1) emergency communication technology or devices used to allow a miner to maintain constant communication with an individual who is not in the mine; (2) electronic identification and location devices that allow individuals not in the mine to track at all times the movements and location of miners working in or at the mine; (3) emergency oxygen-generating, self-rescue devices that provide oxygen for at least 90 minutes; (4) pre-positioned supplies of oxygen providing each miner on a shift the ability to survive for at least 48 hours; and (5) comprehensive atmospheric monitoring systems that monitor the levels of carbon monoxide, methane, and oxygen that are present in all areas of the mine and that can detect smoke in the case of a fire in a mine.<sup>137</sup>

New Federal Law (IRC section 179E)

The provision extends for one year (through December 31, 2017) the present-law placed-in-service date allowing a taxpayer to expense 50 percent of the cost of any qualified advanced mine safety equipment property.

Effective Date

The provision applies to property placed in service after December 31, 2016.

California Law (R&TC sections 17201, 17255, 17257.4, and 24356)

This provision is not applicable under California law.

Under the PITL, California specifically does not conform to the federal election to expense advanced mine safety equipment,<sup>138</sup> and the election has not been adopted under the CTL. Under both the PITL and the CTL, as it relates to the election to deduct (or “expense”) costs in lieu of depreciation, California conforms to IRC section 179, with significant modifications.<sup>139</sup>

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<sup>135</sup> IRC section 179E(a).

<sup>136</sup> IRC section 179E(c) and (g).

<sup>137</sup> IRC section 179E(d).

<sup>138</sup> R&TC section 17257.4.

<sup>139</sup> R&TC sections 17255 and 24356.

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Taxpayers with a sufficiently small amount of annual investment may elect to deduct up to \$25,000 of the cost of qualifying property placed in service for the taxable year. The \$25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000. The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
40308	Extension of Special Expensing Rules for Certain Productions

Background

Under IRC section 181, a taxpayer may elect<sup>140</sup> to deduct the cost of any qualifying film and television 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.<sup>141</sup> A taxpayer may elect to deduct up to \$15 million of the aggregate cost of the film or television production under this section.<sup>142</sup> The threshold is increased to \$20 million if a significant amount of the production expenditures are incurred in areas eligible for designation as a low-income community or eligible for designation by the Delta Regional Authority as a distressed county or isolated area of distress.<sup>143</sup>

A qualified film or television production means any production of a motion picture (whether released theatrically or directly to video cassette or any other format) or television program if at least 75 percent of the total compensation expended on the production is for services performed in the United States by actors, directors, producers, and other relevant production personnel.<sup>144</sup> The term “compensation” does not include participations and residuals (as defined in IRC section 167(g)(7)(B)).<sup>145</sup> 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.<sup>146</sup>

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<sup>140</sup> See Treasury Regulation section 1.181-2 for rules on making an election under this section.

<sup>141</sup> For this purpose, a production is treated as commencing on the first date of principal photography.

<sup>142</sup> IRC section 181(a)(2)(A).

<sup>143</sup> IRC section 181(a)(2)(B).

<sup>144</sup> IRC section 181(d)(3)(A).

<sup>145</sup> IRC section 181(d)(3)(B).

<sup>146</sup> IRC section 181(d)(2)(B).

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Qualified productions do not include sexually explicit productions as referenced by section 2257 of title 18 of the U.S. Code.<sup>147</sup>

For purposes of recapture under IRC section 1245, any deduction allowed under IRC section 181 is treated as if it were a deduction allowable for amortization.<sup>148</sup>

IRC section 181 includes any qualified live theatrical production commencing after December 31, 2015. 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 series of venues the majority of which have an audience capacity of not more than 3,000. 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. In general, in the case of multiple live-staged productions, each such live-staged production is treated as a separate production. 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. 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.

New Federal Law (IRC section 181)

The provision extends the special treatment for film and television productions or qualified live theatrical productions under IRC section 181 for one year to productions commencing prior to January 1, 2018.

Effective Date

The provision generally applies to productions commencing after December 31, 2016.

California Law (R&TC sections 17250, 17201.5, 17250.5, and 24349)

This provision is not applicable under California law.

Under the PITL, California specifically does not conform to the federal election to deduct the cost of any qualifying film and television production in the year the expenditure is incurred in lieu of capitalizing the cost and recovering it through depreciation allowances,<sup>149</sup> and the election has not been adopted under the CTL.

Under both the PITL and the CTL, California generally conforms to the federal income-forecast method to determine the depreciation recovery periods of property such as films,

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<sup>147</sup> IRC section 181(d)(2)(C).

<sup>148</sup> IRC section 1245(a)(2)(C).

<sup>149</sup> R&TC section 17201.5.

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videotapes, television, book rights, patents, master sound recordings, video games, and like items.<sup>150</sup>

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
40309	Extension of Deduction Allowable with Respect to Income Attributable to Domestic Production Activities in Puerto Rico

Background

**In General**

Present law generally provides a deduction from taxable income (or, in the case of an individual, AGI) that is equal to nine percent of the lesser of the taxpayer's qualified production activities income or taxable income for the taxable year. For taxpayers subject to the 35-percent corporate income tax rate, the nine-percent deduction effectively reduces the corporate income tax rate to slightly less than 32 percent on qualified production activities income.

In general, qualified production activities income is equal to domestic production gross receipts reduced by the sum of: (1) the costs of goods sold that are allocable to those receipts; and (2) other expenses, losses, or deductions which are properly allocable to those receipts.

Domestic production gross receipts generally are gross receipts of a taxpayer that are derived from: (1) any sale, exchange, or other disposition, or any lease, rental, or license, of qualifying production property<sup>151</sup> that was manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the United States; (2) any sale, exchange, or other disposition, or any lease, rental, or license, of qualified film<sup>152</sup> produced by the taxpayer; (3) any lease, rental, license, sale, exchange, or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the United States; (4) construction of real property performed in the United States by a taxpayer in the ordinary course of a

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<sup>150</sup> R&TC sections 17250.5 and 24349(f) conform to IRC section 167(g), relating to depreciation under the income forecast method, as of the specified date of January 1, 2015, with modifications.

<sup>151</sup> Qualifying production property generally includes any tangible personal property, computer software, and sound recordings.

<sup>152</sup> Qualified film includes any motion picture film or videotape (including live or delayed television programming, but not including certain sexually explicit productions) if 50 percent or more of the total compensation relating to the production of the film (including compensation in the form of residuals and participations) constitutes compensation for services performed in the United States by actors, production personnel, directors, and producers.

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construction trade or business; or (5) engineering or architectural services performed in the United States for the construction of real property located in the United States.

The amount of the deduction for a taxable year is limited to 50 percent of the wages paid by the taxpayer, and properly allocable to domestic production gross receipts, during the calendar year that ends in such taxable year.<sup>153</sup> Wages paid to bona-fide residents of Puerto Rico generally are not included in the definition of wages for purposes of computing the wage limitation amount.<sup>154</sup>

### **Rules for Puerto Rico**

When used in the IRC in a geographical sense, the term “United States” generally includes only the states and the District of Columbia.<sup>155</sup> A special rule for determining domestic production gross receipts, however, provides that in the case of any taxpayer with gross receipts from sources within the Commonwealth of Puerto Rico, the term “United States” includes the Commonwealth of Puerto Rico, but only if all of the taxpayer’s Puerto Rico-sourced gross receipts are taxable under the federal income tax for individuals or corporations.<sup>156</sup> In computing the 50-percent wage limitation, the taxpayer is permitted to take into account wages paid to bona-fide residents of Puerto Rico for services performed in Puerto Rico.<sup>157</sup>

The special rules for Puerto Rico apply only with respect to the first eleven taxable years of a taxpayer beginning after December 31, 2005, and before January 1, 2017.

### New Federal Law (IRC section 199)

The provision extends the special domestic production activities rules for Puerto Rico to apply for the first twelve taxable years of a taxpayer beginning after December 31, 2005, and before January 1, 2018.

### Effective Date

The provision is effective for taxable years beginning after December 31, 2016.

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<sup>153</sup> For purposes of the provision, “wages” include the sum of the amounts of wages as defined in IRC section 3401(a) and elective deferrals that the taxpayer properly reports to the Social Security Administration with respect to the employment of employees of the taxpayer during the calendar year ending during the taxpayer’s taxable year.

<sup>154</sup> For purposes of the provision, “wages” include the sum of the amounts of wages as defined in IRC section 3401(a) and elective deferrals that the taxpayer properly reports to the Social Security Administration with respect to the employment of employees of the taxpayer during the calendar year ending during the taxpayer’s taxable year.

<sup>155</sup> IRC section 7701(a)(9).

<sup>156</sup> IRC section 199(d)(8)(A).

<sup>157</sup> IRC section 199(d)(8)(B).

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California Law (R&TC sections 17250 and 17201.6)

This provision is not applicable under California law. Under the PITL, California specifically does not conform to the deduction for income attributable to domestic production entities,<sup>158</sup> and the deduction has not been adopted under the CTL.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
40310	Extension of Special Rule Relating to Qualified Timber Gains

Background

**Treatment of Certain Timber Gain**

Under the law prior to the enactment of the PATH Act,<sup>159</sup> if a taxpayer cut standing timber, the taxpayer could elect to treat the cutting as a sale or exchange eligible for capital gains treatment.<sup>160</sup> The fair market value of the timber on the first day of the taxable year in which the timber was cut was used to determine the gain attributable to such cutting. Such fair market value was thereafter considered the taxpayer's cost of the cut timber for all purposes, such as to determine the taxpayer's income from later sales of the timber or timber products. Also, if a taxpayer disposed of the timber with a retained economic interest or made an outright sale of the timber, the gain was eligible for capital gain treatment.<sup>161</sup> This treatment under either IRC section 631(a) or (b) required that the taxpayer had owned the timber or held the contract right for a period of more than one year.

The maximum regular rate of tax on the net capital gain of an individual was 20 percent.<sup>162</sup> Certain gains were subject to an additional 3.8-percent tax.<sup>163</sup>

The net capital gain of a corporation was taxed at the same rates as ordinary income, up to a maximum rate of 35 percent.<sup>164</sup>

Current law provides that for a taxable year beginning in 2016, a 23.8-percent alternative tax rate applies for corporations on the portion of a corporation's taxable income that consists of qualified timber gain (or, if less, the net capital gain).

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<sup>158</sup> R&TC section 17201.6.

<sup>159</sup> Division Q of Public Law 114-113, enacted December 18, 2015.

<sup>160</sup> IRC section 631(a).

<sup>161</sup> IRC section 631(b).

<sup>162</sup> IRC section 1(h).

<sup>163</sup> IRC section 1411.

<sup>164</sup> IRC sections 11 and 1201.



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Qualified timber gain means the net gain described in IRC section 631(a) and (b) for the taxable year beginning in 2016, determined by taking into account only timber held more than 15 years.

New Federal Law (IRC sections 55 and 1201)

The provision extends the alternative tax rate to taxable years that begin in 2016 and 2017.

Effective Date

The provision applies to taxable years beginning in 2016 and 2017.

California Law (R&TC sections 24831, 24990, and 24990.5)

This provision is not applicable under California law.

The CTL conforms to the federal rules for purposes of determining gain or loss on the sale or exchange of timber,<sup>165</sup> and generally conforms to the federal rules for determining net capital gain,<sup>166</sup> as of the specified date of January 1, 2015,<sup>167</sup> but specifically does not conform to IRC section 1201, relating to alternative tax for corporations.<sup>168</sup>

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
40311	Extension of Empowerment Zone Tax Incentives

Background

The Omnibus Budget Reconciliation Act of 1993 (OBRA 93)<sup>169</sup> authorized the designation of nine empowerment zones (“Round I empowerment zones”) to provide tax incentives for businesses to locate within certain targeted areas<sup>170</sup> designated by the Secretaries of the Department of Housing and Urban Development (HUD) and the U.S. Department of

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<sup>165</sup> R&TC section 24831 conforms to Subchapter I of Chapter 1 of Subtitle A of the IRC (IRC sections 611-638), relating to natural resources, as of the specified date of January 1, 2015, except as otherwise provided.

<sup>166</sup> R&TC section 24990 conforms to Subchapter P of Chapter 1 of Subtitle A of the IRC (IRC sections 1201-1298), relating to capital gains and losses, as of the specified date of January 1, 2015, except as otherwise provided.

<sup>167</sup> R&TC section 23051.5.

<sup>168</sup> R&TC section 24990.5.

<sup>169</sup> Public Law 103-66.

<sup>170</sup> The targeted areas are those that have pervasive poverty, high unemployment, and general economic distress, and that satisfy certain eligibility criteria, including specified poverty rates and population and geographic size limitations.

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Agriculture (USDA). The first empowerment zones were established in large rural areas and large cities. OBRA 93 also authorized the designation of 95 enterprise communities, which were located in smaller rural areas and cities. For tax purposes, the areas designated as enterprise communities continued as such for the ten-year period starting in the beginning of 1995 and ending at the end of 2004.

The Taxpayer Relief Act of 1997<sup>171</sup> authorized the designation of two additional Round I urban empowerment zones, and 20 additional empowerment zones (“Round II empowerment zones”). The Community Renewal Tax Relief Act of 2000 (“2000 Community Renewal Act”)<sup>172</sup> authorized a total of 10 new empowerment zones (“Round III empowerment zones”), bringing the total number of authorized empowerment zones to 40.<sup>173</sup> In addition, the 2000 Community Renewal Act conformed to the tax incentives that are available to businesses in the Round I, Round II, and Round III empowerment zones, and extended the empowerment zone incentives through December 31, 2009. Subsequent legislation extended the empowerment zone incentives through December 31, 2016.<sup>174</sup>

The tax incentives available within the designated empowerment zones include a federal income tax credit for employers who hire qualifying employees (the “wage credit”), increased expensing of qualifying depreciable property, tax-exempt bond financing, deferral of capital gains tax on the sale of qualified assets sold and replaced, and partial exclusion of capital gains tax on certain sales of qualified small business stock.

The following is a description of the empowerment zone tax incentives.

### **Wage Credit**

A 20-percent wage credit is available to employers for the first \$15,000 of qualified wages paid to each employee (*i.e.*, a maximum credit of \$3,000 with respect to each qualified employee) who (1) is a resident of the empowerment zone, and (2) performs substantially all

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<sup>171</sup> Public Law 105-34.

<sup>172</sup> Public Law 106-554.

<sup>173</sup> The urban part of the program is administered by HUD and the rural part of the program is administered by the USDA. The eight Round I urban empowerment zones are Atlanta, GA; Baltimore, MD; Chicago, IL; Cleveland, OH; Detroit, MI; Los Angeles, CA; New York, NY; and Philadelphia, PA/Camden, NJ. Atlanta relinquished its empowerment zone designation in Round III. The three Round I rural empowerment zones are Kentucky Highlands, KY; Mid-Delta, MI; and Rio Grande Valley, TX. The 15 Round II urban empowerment zones are Boston, MA; Cincinnati, OH; Columbia, SC; Columbus, OH; Cumberland County, NJ; El Paso, TX; Gary/Hammond/East Chicago, IN; Ironton, OH/Huntington, WV; Knoxville, TN; Miami/Dade County, FL; Minneapolis, MN; New Haven, CT; Norfolk/Portsmouth, VA; Santa Ana, CA; and St. Louis, Missouri/East St. Louis, IL. The five Round II rural empowerment zones are Desert Communities, CA; Griggs-Steele, ND; Oglala Sioux Tribe, SD; Southernmost Illinois Delta, IL; and Southwest Georgia United, GA. The eight Round III urban empowerment zones are Fresno, CA; Jacksonville, FL; Oklahoma City, OK; Pulaski County, AR; San Antonio, TX; Syracuse, NY; Tucson, AZ; and Yonkers, NY. The two Round III rural empowerment zones are Aroostook County, ME; and Futuro, TX.

<sup>174</sup> Public Law 111-312, section 753 (2010), Public Law 112-240, section 327(a) (2013), Public Law 113-295, section 139 (2014), Public Law 114-113, Title I, section 171 (2015).

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employment services within the empowerment zone in a trade or business of the employer.<sup>175</sup>

The wage credit rate applies to qualifying wages paid before January 1, 2017. Wages paid to a qualified employee who earns more than \$15,000 are eligible for the wage credit (although only the first \$15,000 of wages is eligible for the credit). The wage credit is available with respect to a qualified full-time or part-time employee (employed for at least 90 days), regardless of the number of other employees who work for the employer. In general, any taxable business carrying out activities in the empowerment zone may claim the wage credit, regardless of whether the employer meets the definition of an “enterprise zone business.”<sup>176</sup>

An employer’s deduction otherwise allowed for wages paid is reduced by the amount of wage credit claimed for that taxable year.<sup>177</sup> Wages are not to be taken into account for purposes of the wage credit if taken into account in determining the employer’s work opportunity tax credit (WOTC) under IRC section 51.<sup>178</sup> In addition, the \$15,000 cap is reduced by any wages taken into account in computing the WOTC.<sup>179</sup> The wage credit may be used to offset up to 25 percent of the employer’s AMT liability.<sup>180</sup>

### **Increased IRC Section 179 Expensing Limitation**

An enterprise zone business is allowed up to an additional \$35,000 of IRC section 179 expensing for qualified zone property placed in service before January 1, 2017.<sup>181</sup> For taxable years beginning after 2014 and before 2018, the total amount that may be expensed is \$535,000 (assuming at least \$35,000 of qualified zone property is placed in service during the taxable year). For taxable years beginning after 2017, the total amount that may be expensed is \$1,035,000 (assuming at least \$35,000 of qualified zone property is placed in service during the taxable year). The IRC section 179 expensing allowed to a taxpayer is phased out by the amount by which the cost of qualifying property placed in service during the taxable year exceeds a specified dollar amount.<sup>182</sup> However, only 50 percent of the cost of qualified zone property placed in service during the year by the taxpayer is taken into account in determining the phase out of the limitation amount.<sup>183</sup>

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<sup>175</sup> IRC section 1396. The \$15,000 limit is annual, not cumulative, such that the limit is the first \$15,000 of wages paid in a calendar year which ends with or within the taxable year.

<sup>176</sup> IRC sections 1397C(b) and 1397C(c). However, the wage credit is not available for wages paid in connection with certain business activities described in IRC section 144(c)(6)(B), including a golf course, country club, massage parlor, hot tub facility, suntan facility, racetrack, liquor store, or certain farming activities. In addition, wages are not eligible for the wage credit if paid to: (1) a person who owns more than five percent of the stock (or capital or profits interests) of the employer, (2) certain relatives of the employer, or (3) if the employer is a corporation or partnership, certain relatives of a person who owns more than 50 percent of the business.

<sup>177</sup> IRC section 280C(a).

<sup>178</sup> IRC section 1396(c)(3)(A).

<sup>179</sup> IRC section 1396(c)(3)(B).

<sup>180</sup> IRC section 38(c)(2).

<sup>181</sup> IRC section 1397A.

<sup>182</sup> For taxable years beginning in 2014 and before 2018, the dollar amount is \$2,000,000. For taxable years beginning after 2017, the dollar amount is \$2,500,000. IRC section 179(b)(2).

<sup>183</sup> IRC section 1397A(a)(2).

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The term “qualified zone property” is defined as depreciable tangible property (including buildings) provided that (i) the property is acquired by the taxpayer (from an unrelated party) after the designation took effect, (ii) the original use of the property in an empowerment zone commences with the taxpayer, and (iii) substantially all of the use of the property is in an empowerment zone in the active conduct of a trade or business by the taxpayer.<sup>184</sup> Special rules are provided in the case of property that is substantially renovated by the taxpayer.

An enterprise zone business means any qualified business entity and any qualified proprietorship. A qualified business entity means any corporation or partnership if for such year: (1) every trade or business of such entity is the active conduct of a qualified business within an empowerment zone; (2) at least 50 percent of the total gross income of such entity is derived from the active conduct of such business; (3) a substantial portion of the use of the tangible property of such entity (whether owned or leased) is within an empowerment zone; (4) a substantial portion of the intangible property of such entity is used in the active conduct of any such business; (5) a substantial portion of the services performed for such entity by its employees are performed in an empowerment zone; (6) at least 35 percent of its employees are residents of an empowerment zone; (7) less than five percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to collectibles other than collectibles that are held primarily for sale to customers in the ordinary course of such business; and (8) less than five percent of the average of the aggregate unadjusted bases of the property of such entity is attributable to nonqualified financial property.<sup>185</sup>

A qualified proprietorship is any qualified business carried on by an individual as a proprietorship if for such year: (1) at least 50 percent of the total gross income of such individual from such business is derived from the active conduct of such business in an empowerment zone; (2) a substantial portion of the use of the tangible property of such individual in such business (whether owned or leased) is within an empowerment zone; (3) a substantial portion of the intangible property of such business is used in the active conduct of such business; (4) a substantial portion of the services performed for such individual in such business by employees of such business are performed in an empowerment zone; (5) at least 35 percent of such employees are residents of an empowerment zone; (6) less than five percent of the average of the aggregate unadjusted bases of the property of such individual which is used in such business is attributable to collectibles other than collectibles that are held primarily for sale to customers in the ordinary course of such business; and (7) less than five percent of the average of the aggregate unadjusted bases of the property of such individual which is used in such business is attributable to nonqualified financial property.<sup>186</sup>

A qualified business is defined as any trade or business other than a trade or business that consists predominantly of the development or holding of intangibles for sale or license or

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<sup>184</sup> IRC section 1397D. Note, however, that to be eligible for the increased IRC section 179 expensing, the qualified zone property has to also meet the definition of IRC section 179 property (e.g., building property would only qualify if it constitutes qualified real property under IRC section 179(f)).

<sup>185</sup> IRC section 1397C(b).

<sup>186</sup> IRC section 1397C(c).

any business prohibited in connection with the employment credit.<sup>187</sup> In addition, the leasing of real property that is located within the empowerment zone is treated as a qualified business only if (1) the leased property is not residential property, and (2) at least 50 percent of the gross rental income from the real property is from enterprise zone businesses. The rental of tangible personal property is not a qualified business unless at least 50 percent of the rental of such property is by enterprise zone businesses or by residents of an empowerment zone.

### **Expanded Tax-Exempt Financing for Certain Zone Facilities**

States or local governments can issue enterprise zone facility bonds to raise funds to provide an enterprise zone business with qualified zone property.<sup>188</sup> These bonds can be used in areas designated enterprise communities as well as areas designated empowerment zones. To qualify, 95 percent (or more) of the net proceeds from the bond issue must be used to finance: (1) qualified zone property whose principal user is an enterprise zone business, and (2) certain land functionally related and subordinate to such property.

The term enterprise zone business is the same as that used for purposes of the increased IRC section 179 deduction limitation (discussed above) with certain modifications for start-up businesses. First, a business will be treated as an enterprise zone business during a start-up period if (1) at the beginning of the period, it is reasonable to expect the business to be an enterprise zone business by the end of the start-up period, and (2) the business makes bona-fide efforts to be an enterprise zone business. The start-up period is the period that ends with the start of the first tax year beginning more than two years after the later of (1) the issue date of the bond issue financing the qualified zone property, and (2) the date this property is first placed in service (or, if earlier, the date that is three years after the issue date).<sup>189</sup>

Second, a business that qualifies as an enterprise zone business at the end of the start-up period must continue to qualify during a testing period that ends three tax years after the start-up period ends. After the three-year testing period, a business will continue to be treated as an enterprise zone business as long as 35 percent of its employees are residents of an empowerment zone or enterprise community.

The face amount of the bonds may not exceed \$60 million for an empowerment zone in a rural area, \$130 million for an empowerment zone in an urban area with zone population of less than 100,000, and \$230 million for an empowerment zone in an urban area with zone population of at least 100,000.

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<sup>187</sup> IRC section 1397C(d). Excluded businesses include any private or commercial golf course, country club, massage parlor, hot tub facility, sun tan facility, racetrack or other facility used for gambling, or any store the principal business of which is the sale of alcoholic beverages for off-premises consumption. IRC section 144(c)(6).

<sup>188</sup> IRC section 1394.

<sup>189</sup> IRC section 1394(b)(3).

### **Elective Rollover of Capital Gain from the Sale or Exchange of Any Qualified Empowerment Zone Asset**

Taxpayers can elect to defer recognition of gain on the sale of a qualified empowerment zone asset held for more than one year and replaced within 60 days by another qualified empowerment zone asset in the same zone.<sup>190</sup> A qualified empowerment zone asset generally means stock or a partnership interest acquired at original issue for cash in an enterprise zone business, or tangible property originally used in an enterprise zone business by the taxpayer. The deferral is accomplished by reducing the basis of the replacement asset by the amount of the gain recognized on the sale of the asset.

### **Partial Exclusion of Capital Gains on Certain Small Business Stock**

Generally, individuals may exclude a percentage of gain from the sale of certain small business stock acquired at original issue and held at least five years.<sup>191</sup> For stock acquired prior to February 18, 2009, or after December 31, 2014, the percentage is generally 50 percent, except that for empowerment zone stock the percentage is 60 percent for gain attributable to periods before January 1, 2019. For stock acquired after February 17, 2009, a higher percentage (either 75 percent or 100 percent) applies to all small business stock with no additional percentage for empowerment zone stock.<sup>192</sup>

### **Other Tax Incentives**

Other incentives not specific to empowerment zones but beneficial to these areas include the WOTC for employers based on the first year of employment of certain targeted groups, including empowerment zone residents (up to \$2,400 per employee), and qualified zone academy bonds for certain public schools located in an empowerment zone or expected (as of the date of bond issuance) to have at least 35 percent of its students receiving free or reduced lunches.

### **Enterprise Zone Facility Bond Employment Requirement**

For purposes of the employment requirement for tax-exempt enterprise zone facility bonds, an employee is treated as a resident of an empowerment zone for purposes of the 35 percent in-zone employment requirement if they are a resident of an empowerment zone, an enterprise community, or a qualified low-income community within an applicable nominating jurisdiction. The applicable nominating jurisdiction means, with respect to any empowerment zone or enterprise community, any local government that nominated such community for designation under IRC section 1391. The definition of a qualified low-income community is similar to the definition of a low-income community provided in IRC section 45D(e) (concerning eligibility for the new markets tax credit). A “qualified low-income community” is a population census tract with either (1) a poverty rate of at least 20 percent,

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<sup>190</sup> IRC section 1397B.

<sup>191</sup> IRC section 1202.

<sup>192</sup> Section 126 of this Act permanently extends the 100-percent exclusion to small business stock for stock acquired after 2014.



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or (2) median family income which does not exceed 80 percent of the greater of metropolitan area median family income or statewide median family income (for a non-metropolitan census tract, does not exceed 80 percent of statewide median family income). In the case of a population census tract located within a high migration rural county, low-income is defined by reference to 85 percent (as opposed to 80 percent) of statewide median family income. For this purpose, a high migration rural county is any county that, during the 20-year period ending with the year in which the most recent census was conducted, has a net outmigration of inhabitants from the county of at least 10 percent of the population of the county at the beginning of such period.

The Secretary is authorized to designate “targeted populations” as qualified low-income communities. For this purpose, a “targeted population” is defined by reference to section 103(20) of the Riegle Community Development and Regulatory Improvement Act of 1994 (the “Act”) to mean individuals, or an identifiable group of individuals, including an Indian tribe, who are low-income persons or otherwise lack adequate access to loans or equity investments. Section 103(17) of the Act provides that “low-income” means (1) for a targeted population within a metropolitan area, less than 80 percent of the area median family income; and (2) for a targeted population within a non-metropolitan area, less than the greater of (a) 80 percent of the area median family income, or (b) 80 percent of the statewide non-metropolitan area median family income.

New Federal Law (IRC section 1391)

**Extension**

The provision extends for one year, through December 31, 2017, the period for which the designation of an empowerment zone is in effect, thus extending for one year the empowerment zone tax incentives, including the wage credit, increased IRC section 179 expensing for qualifying property, tax-exempt bond financing, and deferral of capital gains tax on the sale of qualified assets replaced with other qualified assets.

In the case of a designation of an empowerment zone the nomination for which included a termination date which is December 31, 2016, termination shall not apply with respect to such designation if the entity which made such nomination amends the nomination to provide for a new termination date in such manner as the Secretary may provide.

Effective Date

The provision generally applies to taxable years beginning after December 31, 2016. The provision regarding the special rule for the employee residence test in the context of tax-exempt enterprise zone facility bonds applies to bonds issued after December 31, 2015.

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California Law (R&TC sections 17053.33, 17053.45, 17053.46, 17053.47, 17053.70, 17053.73, 17053.74, 17053.75, 23612.2, 23622.7, 23622.8, 23626, 23644 and 23646)

California does not conform to the federal empowerment zone tax incentives. Thus, the one-year federal extension of empowerment zone designations is not applicable under California law.

Prior to 2014, California provided its own tax incentives for taxpayers conducting business activities within geographically targeted economic development areas (EDAs), including Enterprise Zones,<sup>193</sup> Manufacturing Enhancement Areas,<sup>194</sup> Targeted Tax Areas,<sup>195</sup> and Local Agency Military Base Recovery Areas.<sup>196</sup> The California EDA hiring credits generally ceased to be operative for taxable years beginning on or after January 1, 2014; however, the credits continue to apply for taxable years beginning on or after January 1, 2014, with respect to qualified employees who are employed by qualified taxpayers within the 60-month period immediately preceding that date.<sup>197</sup>

For taxable years beginning on or after January 1, 2014, and before January 1, 2021, California allows a New Employment Credit that is available to a qualified taxpayer that hires a qualified full-time employee on or after January 1, 2014, and pays or incurs qualified wages attributable to work performed by the qualified full-time employee in a designated census tract or EDA, and that receives a tentative credit reservation for that qualified full-time employee. In addition, an annual certification of employment is required with respect to each qualified full-time employee hired in a previous taxable year. In order to be allowed a credit, the qualified taxpayer must have a net increase in the total number of full-time employees in California.<sup>198</sup>

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
40312	Extension of American Samoa Economic Development Credit

Background

A domestic corporation that was an existing credit claimant with respect to American Samoa and that elected the application of IRC section 936 for its last taxable year beginning before

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<sup>193</sup> R&TC sections 17053.70, 17053.74, 17053.75, 23612.2, and 23622.7.

<sup>194</sup> R&TC sections 17053.47 and 23622.8.

<sup>195</sup> R&TC sections 17053.33, 23633 and 23644.

<sup>196</sup> R&TC sections 17053.45, 17053.46, 23644 and 23646.

<sup>197</sup> See Chapter 69 of the Statutes of 2013.

<sup>198</sup> R&TC sections 17053.73 and 23626.



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January 1, 2006, is allowed a credit based on the corporation's economic activity-based limitation with respect to American Samoa. The credit is not part of the IRC but is computed based on the rules of IRC sections 30A and 936. The credit is allowed for the first eleven taxable years of a corporation that begin after December 31, 2005, and before January 1, 2017.

A corporation was an existing credit claimant with respect to American Samoa if (1) the corporation was engaged in the active conduct of a trade or business within American Samoa on October 13, 1995, and (2) the corporation elected the benefits of the possession tax credit<sup>199</sup> in an election in effect for its taxable year that included October 13, 1995.<sup>200</sup> A corporation that added a substantial new line of business (other than in a qualifying acquisition of all the assets of a trade or business of an existing credit claimant) ceased to be an existing credit claimant as of the close of the taxable year ending before the date on which that new line of business was added.

The amount of the credit allowed to a qualifying domestic corporation under the provision is equal to the sum of the amounts used in computing the corporation's economic activity-based limitation with respect to American Samoa, except that no credit is allowed for the amount of any American Samoa income taxes. Thus, for any qualifying corporation the amount of the credit equals the sum of (1) 60 percent of the corporation's qualified American Samoa wages and allocable employee fringe benefit expenses, and (2) 15 percent of the corporation's depreciation allowances with respect to short-life qualified American Samoa tangible property, plus 40 percent of the corporation's depreciation allowances with respect to medium-life qualified American Samoa tangible property, plus 65 percent of the

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<sup>199</sup> For taxable years beginning before January 1, 2006, certain domestic corporations with business operations in the U.S. possessions were eligible for the possession tax credit. IRC sections 27(b), 936. This credit offset the U.S. tax imposed on certain income related to operations in the U.S. possessions. Subject to certain limitations, the amount of the possession tax credit allowed to any domestic corporation equaled the portion of that corporation's U.S. tax that was attributable to the corporation's non-U.S. source taxable income from (1) the active conduct of a trade or business within a U.S. possession, (2) the sale or exchange of substantially all of the assets that were used in such a trade or business, or (3) certain possessions investment. No deduction or foreign tax credit was allowed for any possessions or foreign tax paid or accrued with respect to taxable income that was taken into account in computing the credit under IRC section 936. Under the economic activity-based limit, the amount of the credit could not exceed an amount equal to the sum of (1) 60 percent of the taxpayer's qualified possession wages and allocable employee fringe benefit expenses, (2) 15 percent of depreciation allowances with respect to short-life qualified tangible property, plus 40 percent of depreciation allowances with respect to medium-life qualified tangible property, plus 65 percent of depreciation allowances with respect to long-life qualified tangible property, and (3) in certain cases, a portion of the taxpayer's possession income taxes. A taxpayer could elect, instead of the economic activity-based limit, a limit equal to the applicable percentage of the credit that otherwise would have been allowable with respect to possession business income, beginning in 1998, the applicable percentage was 40 percent. To qualify for the possession tax credit for a taxable year, a domestic corporation was required to satisfy two conditions. First, the corporation was required to derive at least 80 percent of its gross income for the three-year period immediately preceding the close of the taxable year from sources within a possession. Second, the corporation was required to derive at least 75 percent of its gross income for that same period from the active conduct of a possession business. IRC section 936(a)(2). The IRC section 936 credit generally expired for taxable years beginning after December 31, 2005.

<sup>200</sup> A corporation will qualify as an existing credit claimant if it acquired all the assets of a trade or business of a corporation that (1) actively conducted that trade or business in a possession on October 13, 1995, and (2) had elected the benefits of the possession tax credit in an election in effect for the taxable year that included October 13, 1995.

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corporation's depreciation allowances with respect to long-life qualified American Samoa tangible property.

The IRC section 936(c) rule denying a credit or deduction for any possessions or foreign tax paid with respect to taxable income taken into account in computing the credit under IRC section 936 does not apply with respect to the credit allowed by the provision.

For taxable years beginning after December 31, 2011, the credit rules are modified in two ways. First, domestic corporations with operations in American Samoa are allowed the credit even if those corporations are not existing credit claimants. Second, the credit is available to a domestic corporation (either an existing credit claimant or a new credit claimant) only if, in addition to satisfying all the present law requirements for claiming the credit, the corporation also has qualified production activities income (as defined in IRC section 199(c) by substituting "American Samoa" for "the United States" in each place that latter term appears).

In the case of a corporation that is an existing credit claimant with respect to American Samoa and that elected the application of IRC section 936 for its last taxable year beginning before January 1, 2006, the credit applies to the first eleven taxable years of the corporation which begin after December 31, 2005, and before January 1, 2017. For any other corporation, the credit applies to the first five taxable years of that corporation which begin after December 31, 2011, and before January 1, 2017.

New Federal Law (IRC section 30A)

The provision extends the credit for one year to apply (1) in the case of a corporation that is an existing credit claimant with respect to American Samoa and that elected the application of IRC section 936 for its last taxable year beginning before January 1, 2006, to the first twelve taxable years of the corporation which begin after December 31, 2005, and before January 1, 2018, and (2) in the case of any other corporation, to the first six taxable years of the corporation which begin after December 31, 2011, and before January 1, 2018.

Effective Date

The provision applies to taxable years beginning after December 31, 2016.

California Law (None)

California does not conform to the American Samoa economic development credit.

Impact on California Revenue

Not applicable.

**Subtitle C—Incentives for Energy Production and Conservation**

<u>Section</u>	<u>Section Title</u>
40401	Extension of Credit for Nonbusiness Energy Property

Background

Present law provides a 10-percent credit for the purchase of qualified energy efficiency improvements to existing homes.<sup>201</sup> A qualified energy efficiency improvement is any energy efficiency building envelope component (1) that meets or exceeds the prescriptive criteria for such a component established by the 2009 International Energy Conservation Code as such Code (including supplements) is in effect on the date of the enactment of the American Recovery and Reinvestment Tax Act of 2009,<sup>202</sup> (or, in the case of windows, skylights and doors, and metal roofs with appropriate pigmented coatings or asphalt roofs with appropriate cooling granules, meets the Energy Star program requirements); (2) that is installed in or on a dwelling located in the United States and owned and used by the taxpayer as the taxpayer's principal residence; (3) the original use of which commences with the taxpayer; and (4) that reasonably can be expected to remain in use for at least five years. The credit is nonrefundable.

Building envelope components are: (1) insulation materials or systems that are specifically and primarily designed to reduce the heat loss or gain for a dwelling and that meet the prescriptive criteria for such material or system established by the 2009 International Energy Conservation Code, as such Code (including supplements) is in effect on the date of the enactment of the American Recovery and Reinvestment Tax Act of 2009;<sup>203</sup> (2) exterior windows (including skylights) and doors; and (3) metal or asphalt roofs with appropriate pigmented coatings or cooling granules that are specifically and primarily designed to reduce the heat gain for a dwelling.

Additionally, present law provides specified credits for the purchase of specific energy efficient property originally placed in service by the taxpayer during the taxable year. The allowable credit for the purchase of certain property is (1) \$50 for each advanced main air circulating fan, (2) \$150 for each qualified natural gas, propane, or oil furnace or hot water boiler, and (3) \$300 for each item of energy efficient building property.

An advanced main air circulating fan is a fan used in a natural gas, propane, or oil furnace and that has an annual electricity use of no more than two percent of the total annual energy use of the furnace (as determined in the standard Department of Energy test procedures).

A qualified natural gas, propane, or oil furnace or hot water boiler is a natural gas, propane, or oil furnace or hot water boiler with an annual fuel utilization efficiency rate of at least 95.

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<sup>201</sup> IRC section 25C.

<sup>202</sup> Public Law 111-5, February 17, 2009.

<sup>203</sup> Ibid.

Bipartisan Budget Act of 2018  
Public Law 115-123, February 9, 2018

Energy-efficient building property is: (1) an electric heat pump water heater which yields an energy factor of at least 2.0 in the standard Department of Energy test procedure, (2) an electric heat pump which achieves the highest efficiency tier established by the Consortium for Energy Efficiency, as in effect on January 1, 2009,<sup>204</sup> (3) a central air conditioner which achieves the highest efficiency tier established by the Consortium for Energy Efficiency as in effect on January 1, 2009,<sup>205</sup> (4) a natural gas, propane, or oil water heater which has an energy factor of at least 0.82 or thermal efficiency of at least 90 percent, and (5) biomass fuel property.

Biomass fuel property is a stove that burns biomass fuel to heat a dwelling unit located in the United States and used as a principal residence by the taxpayer, or to heat water for such dwelling unit, and that has a thermal efficiency rating of at least 75 percent. Biomass fuel is any plant-derived fuel available on a renewable or recurring basis, including agricultural crops and trees, wood and wood waste and residues (including wood pellets), plants (including aquatic plants), grasses, residues, and fibers.

The credit is available for property placed in service prior to January 1, 2017. The maximum credit for a taxpayer for all taxable years is \$500, and no more than \$200 of such credit may be attributable to expenditures on windows.

The taxpayer's basis in the property is reduced by the amount of the credit. Special proration rules apply in the case of jointly owned property, condominiums, and tenant-stockholders in cooperative housing corporations. If less than 80 percent of the property is used for nonbusiness purposes, only that portion of expenditures that is used for nonbusiness purposes is taken into account.

For purposes of determining the amount of expenditures made by any individual with respect to any dwelling unit, expenditures which are made from subsidized energy financing are not taken into account. The term "subsidized energy financing" means financing provided under a federal, state, or local program a principal purpose of which is to provide subsidized financing for projects designed to conserve or produce energy.

Additionally, for property placed in service after December 31, 2015, the efficiency standard is modified to require that windows, skylights, and doors meet Energy Star 6.0 standards.

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<sup>204</sup> These standards are a seasonal energy efficiency ratio (SEER) greater than or equal to 15, an energy efficiency ratio (EER) greater than or equal to 12.5, and heating seasonal performance factor (HSPF) greater than or equal to 8.5 for split heat pumps, and SEER greater than or equal to 14, EER greater than or equal to 12, and HSPF greater than or equal to 8.0 for packaged heat pumps.

<sup>205</sup> These standards are a SEER greater than or equal to 16 and EER greater than or equal to 13 for split systems, and SEER greater than or equal to 14 and EER greater than or equal to 12 for packaged systems.

Bipartisan Budget Act of 2018  
Public Law 115-123, February 9, 2018

New Federal Law (IRC section 25C)

The provision extends the credit for one year, through December 31, 2017.

Effective Date

The provision is effective for property placed in service after December 31, 2016.

California Law (None)

California does not conform to the credit for nonbusiness energy property.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
40402	Modification and Extension of Credit for Residential Energy Property

Background

**In General**

Present law (IRC section 25D) provides a personal tax credit for the purchase of qualified solar electric property and qualified solar water heating property that is used exclusively for purposes other than heating swimming pools and hot tubs. The credit is equal to 30 percent of qualifying expenditures for property placed in service after 2016 and before 2020. The credit rate is reduced to 26 percent for property placed in service in 2020, and 22 percent for property placed in service in 2021.

IRC section 25D also provides a 30 percent credit for the purchase of qualified geothermal heat pump property, qualified small wind energy property, and qualified fuel cell power plants. The credit for any fuel cell may not exceed \$500 for each 0.5 kilowatt of capacity.

The credit is nonrefundable. The credit with respect to all qualifying property may be claimed against the AMT.

The credit applies to qualified geothermal heat pump property, qualified small wind energy property, and qualified fuel cell power plants placed in service prior to January 1, 2017, and to qualified solar electric property and qualified solar water heating property placed in service prior to January 1, 2022.

## Qualified Property

Qualified solar electric property is property that uses solar energy to generate electricity for use in a dwelling unit. Qualifying solar water heating property is property used to heat water for use in a dwelling unit located in the United States and used as a residence if at least half of the energy used by such property for such purpose is derived from the sun.

A qualified fuel cell power plant is an integrated system comprised of a fuel cell stack assembly and associated balance of plant components that (1) converts a fuel into electricity using electrochemical means, (2) has an electricity-only generation efficiency of greater than 30 percent, and (3) has a nameplate capacity of at least 0.5 kilowatt. The qualified fuel cell power plant must be installed on or in connection with a dwelling unit located in the United States and used by the taxpayer as a principal residence.

Qualified small wind energy property is property that uses a wind turbine to generate electricity for use in a dwelling unit located in the United States and used as a residence by the taxpayer.

Qualified geothermal heat pump property means any equipment which (1) uses the ground or ground water as a thermal energy source to heat the dwelling unit or as a thermal energy sink to cool such dwelling unit, (2) meets the requirements of the Energy Star program which are in effect at the time that the expenditure for such equipment is made, and (3) is installed on or in connection with a dwelling unit located in the United States and used as a residence by the taxpayer.

## Additional Rules

The depreciable basis of the property is reduced by the amount of the credit. Expenditures for labor costs allocable to onsite preparation, assembly, or original installation of property eligible for the credit are eligible expenditures.

Special proration rules apply in the case of jointly owned property, condominiums, and tenant-stockholders in cooperative housing corporations. If less than 80 percent of the property is used for nonbusiness purposes, only that portion of expenditures that is used for nonbusiness purposes is taken into account.

### New Federal Law (IRC section 25D)

The provision extends the credit for five years, through December 31, 2021, for qualified geothermal heat pump property, qualified small wind energy property, and qualified fuel cell power plants. The provision also changed the qualified solar electric property and qualified solar water heating property credit to 30 percent of qualifying expenditures for property placed in service after 2016 and before 2022.

### Effective Dates

The provision is effective for property placed in service after December 31, 2016.

Bipartisan Budget Act of 2018  
Public Law 115-123, February 9, 2018

California Law (None)

California does not conform to the credit for nonbusiness energy property.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
40403	Extension of Credit for New Qualified Fuel Cell Motor Vehicles

Background

A credit is available through 2016 for vehicles propelled by chemically combining oxygen with hydrogen and creating electricity (“fuel cell vehicles”). The base credit is \$4,000 for vehicles weighing 8,500 pounds or less. Heavier vehicles may qualify for up to a \$40,000 credit, depending on their weight. An additional \$1,000 to \$4,000 credit is available to cars and light trucks to the extent their fuel economy exceeds the 2002 base fuel economy set forth in the IRC.

New Federal Law (IRC section 30B)

The provision extends the credit for fuel cell vehicles for one year, through December 31, 2017.

Effective Date

The provision is effective for property purchased after December 31, 2016.

California Law (None)

California does not conform to the credit for new qualified fuel cell motor vehicles.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
40404	Extension of Credit for Alternative Fuel Vehicle Refueling Property



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Background

Taxpayers may claim a 30-percent credit for the cost of installing qualified clean-fuel vehicle refueling property to be used in a trade or business of the taxpayer or installed at the principal residence of the taxpayer.<sup>206</sup> The credit may not exceed \$30,000 per taxable year per location, in the case of qualified refueling property used in a trade or business and \$1,000 per taxable year per location, in the case of qualified refueling property installed on property which is used as a principal residence.

Qualified refueling property is property (not including a building or its structural components) for the storage or dispensing of a clean-burning fuel or electricity into the fuel tank or battery of a motor vehicle propelled by such fuel or electricity, but only if the storage or dispensing of the fuel or electricity is at the point of delivery into the fuel tank or battery of the motor vehicle. The original use of such property must begin with the taxpayer.

Clean-burning fuels are any fuel at least 85 percent of the volume of which consists of ethanol, natural gas, compressed natural gas, liquefied natural gas, liquefied petroleum gas, or hydrogen. In addition, any mixture of biodiesel and diesel fuel, determined without regard to any use of kerosene and containing at least 20 percent biodiesel, qualifies as a clean fuel.

Credits for qualified refueling property used in a trade or business are part of the general business credit and may be carried back for one year and forward for 20 years. Credits for residential qualified refueling property cannot exceed for any taxable year the difference between the taxpayer's regular tax (reduced by certain other credits) and the taxpayer's tentative minimum tax. Generally, in the case of qualified refueling property sold to a tax-exempt entity, the taxpayer selling the property may claim the credit.

A taxpayer's basis in qualified refueling property is reduced by the amount of the credit. In addition, no credit is available for property used outside the United States or for which an election to expense has been made under IRC section 179.

The credit is available for property placed in service before January 1, 2017.

New Federal Law (IRC section 30C)

The provision extends for one year the 30-percent credit for alternative fuel refueling property, through December 31, 2017.

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<sup>206</sup> IRC section 30C.

Bipartisan Budget Act of 2018  
Public Law 115-123, February 9, 2018

Effective Date

The provision is effective for property placed in service after December 31, 2016.

California Law (None)

California does not conform to the credit for alternative fuel vehicle refueling property.

Impact on California Revenue

Not applicable.

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Section

Section Title

40405

Extension of Credit for 2-Wheeled Plug-In Electric Vehicles

Background

For vehicles acquired during 2015 and 2016, a 10-percent credit was available for qualifying two-wheeled plug-in electric motorcycles.<sup>207</sup> Qualifying two-wheeled vehicles needed to have a battery capacity of at least 2.5 kilowatt-hours, be manufactured primarily for use on public streets, roads, and highways, and be capable of achieving speeds of at least 45 miles per hour. The maximum credit for any qualifying vehicle was \$2,500.

New Federal Law (IRC section 30D)

The provision extends for one year the 10-percent credit for two-wheeled electric motorcycles through December 31, 2017.

Effective Date

The provision is effective for vehicles acquired after December 31, 2016.

California Law (None)

California does not conform to the credit for two-wheeled plug-in electric vehicles.

Impact on California Revenue

Not applicable.

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<sup>207</sup> IRC section 30D(g).

Bipartisan Budget Act of 2018  
Public Law 115-123, February 9, 2018

<u>Section</u>	<u>Section Title</u>
40406	Extension of Second Generation Biofuel Producer Credit

Background

The second generation biofuel producer credit is a nonrefundable income tax credit for each gallon of qualified second generation biofuel fuel production of the producer for the taxable year. The amount of the credit per gallon is \$1.01. The provision does not apply to qualified second generation biofuel production after December 31, 2016.

“Qualified second generation biofuel production” is any second generation biofuel which is produced by the taxpayer and which, during the taxable year, is: (1) sold by the taxpayer to another person (a) for use by such other person in the production of a qualified second generation biofuel mixture in such person’s trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or (c) who sells such second generation biofuel at retail to another person and places such cellulosic biofuel in the fuel tank of such other person; or (2) used by the producer for any purpose described in (1)(a), (b), or (c).<sup>208</sup> Special rules apply for fuel derived from algae.

“Second generation biofuel” means any liquid fuel that (1) is produced in the United States and used as fuel in the United States, (2) is derived by or from qualified feedstocks and (3) meets the registration requirements for fuels and fuel additives established by the Environmental Protection Agency (EPA) under section 211 of the Clean Air Act. “Qualified feedstock” means any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis, and any cultivated algae, cyanobacteria or lemna. Second generation biofuel does not include fuels that (1) are more than four percent (determined by weight) water and sediment in any combination, (2) have an ash content of more than one percent (determined by weight), or (3) have an acid number greater than 25 (“unprocessed or excluded fuels”). It also does not include any alcohol with a proof of less than 150.

The second generation biofuel producer credit cannot be claimed unless the taxpayer is registered by the IRS as a producer of second generation biofuel. Second generation biofuel eligible for the IRC section 40 credit is precluded from qualifying as biodiesel, renewable diesel, or alternative fuel for purposes of the applicable income tax credit, excise tax credit, or payment provisions relating to those fuels.

Because it is a credit under IRC section 40(a), the second generation biofuel producer credit (credit) is part of the GBC in IRC section 38. However, the credit can only be carried forward three taxable years after the termination of the credit. The credit is also allowable against the AMT. Under IRC section 87, the credit is included in gross income.

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<sup>208</sup> In addition, for fuels derived from algae, cyanobacteria, or lemna, a special rule provides that qualified second generation biofuel includes fuel that is sold by the taxpayer to another person for refining by such other person into a fuel that meets the registration requirements for fuels and fuel additives under section 211 of the Clean Air Act.

Bipartisan Budget Act of 2018  
Public Law 115-123, February 9, 2018

New Federal Law (IRC section 40)

The provision extends the credit one year, through December 31, 2017.

Effective Date

The provision is effective for qualified second generation biofuel production after December 31, 2016.

California Law (None)

California does not conform to the second generation biofuel producer credit.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
40407	Extension of Biodiesel and Renewable Diesel Incentives

Background

**Biodiesel**

Present law provides an income tax credit for biodiesel fuels (the “biodiesel fuels credit”). The biodiesel fuels credit is the sum of three credits: (1) the biodiesel mixture credit, (2) the biodiesel credit, and (3) the small agri-biodiesel producer credit. The biodiesel fuels credit is treated as a general business credit. The amount of the biodiesel fuels credit is includible in gross income.

The biodiesel fuels credit (credit) is coordinated to take into account benefits from the biodiesel excise tax credit and payment provisions discussed below. The credit does not apply to fuel sold or used after December 31, 2016.

Biodiesel is monoalkyl esters of long chain fatty acids derived from plant or animal matter that meet (1) the registration requirements established by the EPA under section 211 of the Clean Air Act (42 U.S.C. section 7545) and (2) the requirements of the American Society of Testing and Materials (ASTM) D6751. Agri-biodiesel is biodiesel derived solely from virgin oils including oils from corn, soybeans, sunflower seeds, cottonseeds, canola, crambe, rapeseeds, safflowers, flaxseeds, rice bran, mustard seeds, camelina, or animal fats.

Biodiesel may be taken into account for purposes of the credit only if the taxpayer obtains a certification (in such form and manner as prescribed by the Secretary) from the producer or importer of the biodiesel that identifies the product produced and the percentage of biodiesel and agri-biodiesel in the product.

### **Biodiesel Mixture Credit**

The biodiesel mixture credit is \$1.00 for each gallon of biodiesel (including agri-biodiesel) used by the taxpayer in the production of a qualified biodiesel mixture. A qualified biodiesel mixture is a mixture of biodiesel and diesel fuel that is (1) sold by the taxpayer producing such mixture to any person for use as a fuel, or (2) used as a fuel by the taxpayer producing such mixture. The sale or use must be in the trade or business of the taxpayer and is to be taken into account for the taxable year in which such sale or use occurs. No credit is allowed with respect to any casual off-farm production of a qualified biodiesel mixture.

Per IRS guidance a mixture need only contain 1/10th of one percent of diesel fuel to be a qualified mixture. Thus, a qualified biodiesel mixture can contain 99.9 percent biodiesel and 0.1 percent diesel fuel.

### **Biodiesel Credit (B-100)**

The biodiesel credit is \$1.00 for each gallon of biodiesel that is not in a mixture with diesel fuel (100 percent biodiesel or B-100) and which during the taxable year is (1) used by the taxpayer as a fuel in a trade or business, or (2) sold by the taxpayer at retail to a person and placed in the fuel tank of such person's vehicle.

### **Small Agri-Biodiesel Producer Credit**

The IRC provides a small agri-biodiesel producer income tax credit, in addition to the biodiesel and biodiesel mixture credits. The credit is 10 cents per gallon for up to 15 million gallons of agri-biodiesel produced by small producers, defined generally as persons whose agri-biodiesel production capacity does not exceed 60 million gallons per year. The agri-biodiesel must (1) be sold by such producer to another person (a) for use by such other person in the production of a qualified biodiesel mixture in such person's trade or business (other than casual off-farm production), (b) for use by such other person as a fuel in a trade or business, or, (c) who sells such agri-biodiesel at retail to another person and places such agri-biodiesel in the fuel tank of such other person; or (2) used by the producer for any purpose described in (a), (b), or (c).

### **Biodiesel Mixture Excise Tax Credit**

The IRC also provides an excise tax credit for biodiesel mixtures. The credit is \$1.00 for each gallon of biodiesel used by the taxpayer in producing a biodiesel mixture for sale or use in a trade or business of the taxpayer. A biodiesel mixture is a mixture of biodiesel and diesel fuel that (1) is sold by the taxpayer producing such mixture to any person for use as a fuel, or (2) is used as a fuel by the taxpayer producing such mixture. No credit is allowed unless the taxpayer obtains a certification (in such form and manner as prescribed by the Secretary) from the producer of the biodiesel that identifies the product produced and the percentage of biodiesel and agri-biodiesel in the product.

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**Public Law 115-123, February 9, 2018**

The credit is not available for any sale or use for any period after December 31, 2016. This excise tax credit is coordinated with the income tax credit for biodiesel such that credit for the same biodiesel cannot be claimed for both income and excise tax purposes.

### **Payments With Respect to Biodiesel Fuel Mixtures**

If any person produces a biodiesel fuel mixture in such person's trade or business, the Secretary is to pay such person an amount equal to the biodiesel mixture credit. The biodiesel fuel mixture credit must first be taken against tax liability for taxable fuels, and to the extent the biodiesel fuel mixture credit exceeds such tax liability, the excess may be received as a payment. Thus, if the person has no IRC section 4081 liability, the credit is refundable. The Secretary is not required to make payments with respect to biodiesel fuel mixtures sold or used after December 31, 2016.

### **Renewable Diesel**

"Renewable diesel" is liquid fuel that (1) is derived from biomass (as defined in IRC section 45K(c)(3)), (2) meets the registration requirements for fuels and fuel additives established by the EPA under section 211 of the Clean Air Act, and (3) meets the requirements of the ASTM D975 or D396, or equivalent standard established by the Secretary. ASTM D975 provides standards for diesel fuel suitable for use in diesel engines. ASTM D396 provides standards for fuel oil intended for use in fuel-oil burning equipment, such as furnaces. Renewable diesel also includes fuel derived from biomass that meets the requirements of a Department of Defense specification for military jet fuel or an ASTM specification for aviation turbine fuel.

For purposes of the IRC, renewable diesel is generally treated the same as biodiesel. In the case of renewable diesel that is aviation fuel, kerosene is treated as though it were diesel fuel for purposes of a qualified renewable diesel mixture. Like biodiesel, the incentive may be taken as an income tax credit, an excise tax credit, or as a payment from the Secretary. The incentive for renewable diesel is \$1.00 per gallon. There is no small producer credit for renewable diesel. The incentives for renewable diesel expired after December 31, 2016.

For fuel sold or used in 2015, a special rule addresses claims regarding excise tax credits and claims for payment for the period beginning on January 1, 2015, and ending on December 31, 2015. In particular the Secretary was directed to issue guidance within 30 days of the date of enactment of the Consolidated Appropriations Act, 2016.<sup>209</sup> Such guidance is to provide for a one-time submission of claims covering periods occurring during 2015. The guidance is to provide for a 180-day period for the submission of such claims (in such manner as prescribed by the Secretary) to begin no later than 30 days after such guidance is issued. Such claims shall be paid by the Secretary not later than 60 days after receipt. If the claim is not paid within 60 days of the date of the filing, the claim shall be paid with interest from such date determined by using the overpayment rate and method under IRC section 6621.

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<sup>209</sup> Public Law 114-113, Division P, Section 201, enacted December 18, 2015.

Bipartisan Budget Act of 2018  
Public Law 115-123, February 9, 2018

New Federal Law (IRC section 40A)

The provision extends the present-law income tax credit, excise tax credit, and payment provisions for biodiesel and renewable diesel through December 31, 2017. As it relates to fuel sold or used in 2017, the provision creates a special rule to address claims regarding excise tax credits and claims for payment for the period beginning on January 1, 2017, and ending on December 31, 2017. In particular the provision directs the Secretary to issue guidance within 30 days of the date of enactment. Such guidance is to provide for a one-time submission of claims covering periods occurring during 2017. The guidance is to provide for a 180-day period for the submission of such claims (in such manner as prescribed by the Secretary) to begin no later than 30 days after such guidance is issued. Such claims shall be paid by the Secretary not later than 60 days after receipt. If the claim is not paid within 60 days of the date of the filing, the claim shall be paid with interest from such date determined by using the overpayment rate and method under IRC section 6621.

Effective Date

The extension of present law is effective for fuel sold or used after December 31, 2016.

California Law (None)

California does not conform to the biodiesel and renewable diesel income tax incentives.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
40408	Extension of Production Credit for Indian Coal Facilities

Background

A credit is available for the production of Indian coal sold to an unrelated third party, or to a related-party so long as the Indian coal is subsequently sold to an unrelated third person, from a qualified facility for an eleven-year period beginning January 1, 2006, and ending December 31, 2016. The amount of the credit is \$2.00 per ton (adjusted for inflation; \$2.387 for 2016). A qualified Indian coal facility is a facility placed in service before January 1, 2009, that produces coal from reserves that on June 14, 2005, were owned by a federally recognized tribe of Indians or were held in trust by the United States for a tribe or its members.



**Bipartisan Budget Act of 2018**  
**Public Law 115-123, February 9, 2018**

The credit is a component of the general business credit,<sup>210</sup> allowing excess credits to be carried back one year and forward up to 20 years. The credit is not permitted against the AMT.

New Federal Law (IRC section 45)

The provision extends the credit for the production of Indian coal for one year through December 31, 2017.

Effective Date

The extension of the credit is effective for Indian coal produced after December 31, 2016.

California Law (None)

California does not conform to the production credit for Indian coal facilities.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
40409	Extension of Credits with Respect to Facilities Producing Energy from Certain Renewable Resources

Background

**Renewable Electricity Production Credit**

An income tax credit is allowed for the production of electricity from qualified energy resources at qualified facilities (the “renewable electricity production credit”).<sup>211</sup> Qualified energy resources comprise wind, closed-loop biomass, open-loop biomass, geothermal energy, solar energy, small irrigation power, municipal solid waste, qualified hydropower production, and marine and hydrokinetic renewable energy.

Qualified facilities are, generally, facilities that generate electricity using qualified energy resources. To be eligible for the credit, electricity produced from qualified energy resources at qualified facilities must be sold by the taxpayer to an unrelated person.

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<sup>210</sup> IRC section 38(b)(8).

<sup>211</sup> IRC section 45. In addition to the renewable electricity production credit, IRC section 45 also provides income tax credits for the production of Indian coal and refined coal at qualified facilities.

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<b>Summary of Credit for Electricity Produced from Certain Renewable Resources</b>		
Eligible Electricity Production Activity (IRC section 45)	Credit Amount for 2015 <sup>1</sup> (cents per kilowatt hour)	Expiration <sup>2</sup>
Wind	2.3	December 31, 2019
Closed-loop biomass	2.3	December 31, 2016
Open-loop biomass (including agricultural livestock waste nutrient facilities)	1.2	December 31, 2016
Geothermal	2.3	December 31, 2016
Municipal solid waste (including landfill gas facilities and trash combustion facilities)	1.2	December 31, 2016
Qualified hydropower	1.2	December 31, 2016
Marine and hydrokinetic	1.2	December 31, 2016
<sup>1</sup> In general, the credit is available for electricity produced during the first 10 years after a facility has been placed in service. <sup>2</sup> Expires for property the construction of which begins after this date.		

### **Election to Claim Energy Credit in Lieu of Renewable Electricity Production Credit**

A taxpayer may make an irrevocable election to have certain property which is part of a qualified renewable electricity production facility be treated as energy property eligible for a 30-percent investment credit under IRC section 48. For this purpose, qualified facilities are facilities otherwise eligible for the renewable electricity production credit with respect to which no credit under IRC section 45 has been allowed. A taxpayer electing to treat a facility as energy property may not claim the renewable electricity production credit. The eligible basis for the investment credit for taxpayers making this election is the basis of the depreciable (or amortizable) property that is part of a facility capable of generating electricity eligible for the renewable electricity production credit.

#### New Federal Law (IRC sections 45 and 48)

Except for wind facilities, the provision extends for one year the renewable electricity production credit and the election to claim the energy credit in lieu of the electricity production credit through December 31, 2017.

#### Effective Date

The provision is effective on January 1, 2017.

#### California Law (None)

California does not conform to the credits with respect to facilities producing energy from certain renewable resources.

Bipartisan Budget Act of 2018  
Public Law 115-123, February 9, 2018

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
40410	Extension of Credit for Energy-Efficient New Homes

Background

Present law provides a credit to an eligible contractor for each qualified new energy-efficient home that is constructed by the eligible contractor and acquired by a person from such eligible contractor for use as a residence during the taxable year. To qualify as a new energy-efficient home, the home must be: (1) a dwelling located in the United States, (2) substantially completed after August 8, 2005, and (3) certified in accordance with guidance prescribed by the Secretary to have a projected level of annual heating and cooling energy consumption that meets the standards for either a 30-percent or 50-percent reduction in energy usage, compared to a comparable dwelling constructed in accordance with the standards of chapter 4 of the 2006 International Energy Conservation Code as in effect (including supplements) on January 1, 2006, and any applicable federal minimum efficiency standards for equipment. With respect to homes that meet the 30-percent standard, one-third of such 30-percent savings must come from the building envelope, and with respect to homes that meet the 50-percent standard, one-fifth of such 50-percent savings must come from the building envelope.

Manufactured homes that conform to federal manufactured home construction and safety standards are eligible for the credit provided all the criteria for the credit are met. The eligible contractor is the person who constructed the home, or in the case of a manufactured home, the producer of such home.

The credit equals \$1,000 in the case of a new home that meets the 30-percent standard and \$2,000 in the case of a new home that meets the 50-percent standard. Only manufactured homes are eligible for the \$1,000 credit.

In lieu of meeting the standards of chapter 4 of the 2006 International Energy Conservation Code, manufactured homes certified by a method prescribed by the Administrator of the Environmental Protection Agency under the Energy Star Labeled Homes program are eligible for the \$1,000 credit provided criteria (1) and (2), above, are met.

The credit applies to homes that are purchased prior to January 1, 2017. The credit is part of the general business credit.

New Federal Law (IRC section 45L)

The provision extends the credit to homes that are acquired prior to January 1, 2018.

Bipartisan Budget Act of 2018  
Public Law 115-123, February 9, 2018

Effective Date

The provision is effective for homes acquired after December 31, 2016.

California Law (None)

California does not conform to the credit for energy-efficient new homes.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
40411	Extension and Phaseout of Energy Credit

Background

**In General**

A nonrefundable, 10-percent business energy credit<sup>212</sup> is allowed for the cost of new property that is equipment that either (1) uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat or (2) is used to produce, distribute, or use energy derived from a geothermal deposit, but only, in the case of electricity generated by geothermal power, up to the electric transmission stage. Property used to generate energy for the purposes of heating a swimming pool is not eligible solar energy property.

The energy credit is a component of the general business credit.<sup>213</sup> An unused general business credit generally may be carried back one year and carried forward 20 years.<sup>214</sup> The taxpayer's basis in the property is reduced by one-half of the amount of the credit claimed. For projects whose construction time is expected to equal or exceed two years, the credit may be claimed as progress expenditures are made on the project, rather than during the year the property is placed in service. The credit is allowed against the AMT.

**Special Rules for Solar Energy Property**

The credit rate is 30 percent for 2017, 2018 and 2019; 26 percent for 2020; and 22 percent for 2021. The credit rate is 10 percent for 2022 and thereafter. The credit rate is determined by the year in which construction of the property commences, and applies at the time the property is placed in service. Property must be placed in service prior to December 31, 2023, to qualify for a credit rate in excess of 10 percent.

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<sup>212</sup> IRC section 48.

<sup>213</sup> IRC section 38(b)(1).

<sup>214</sup> IRC section 39.

### **Fuel Cells and Microturbines**

The energy credit applies to qualified fuel cell power plants, but only for periods prior to January 1, 2017. The credit rate is 30 percent.

A qualified fuel cell power plant is an integrated system composed of a fuel cell stack assembly and associated balance of plant components that (1) converts a fuel into electricity using electrochemical means, and (2) has an electricity-only generation efficiency of greater than 30 percent and a capacity of at least one-half kilowatt. The credit may not exceed \$1,500 for each 0.5 kilowatt of capacity.

The energy credit applies to qualifying stationary microturbine power plants for periods prior to January 1, 2017. The credit is limited to the lesser of 10 percent of the basis of the property or \$200 for each kilowatt of capacity.

A qualified stationary microturbine power plant is an integrated system comprised of a gas turbine engine, a combustor, a recuperator or regenerator, a generator or alternator, and associated balance of plant components that converts a fuel into electricity and thermal energy. Such system also includes all secondary components located between the existing infrastructure for fuel delivery and the existing infrastructure for power distribution, including equipment and controls for meeting relevant power standards, such as voltage, frequency and power factors. Such system must have an electricity-only generation efficiency of not less than 26 percent at International Standard Organization conditions and a capacity of less than 2,000 kilowatts.

### **Geothermal Heat Pump Property**

The energy credit applies to qualified geothermal heat pump property placed in service prior to January 1, 2017. The credit rate is 10 percent. Qualified geothermal heat pump property is equipment that uses the ground or ground water as a thermal energy source to heat a structure or as a thermal energy sink to cool a structure.

### **Small Wind Property**

The energy credit applies to qualified small wind energy property placed in service prior to January 1, 2017. The credit rate is 30 percent. Qualified small wind energy property is property that uses a qualified wind turbine to generate electricity. A qualifying wind turbine means a wind turbine of 100 kilowatts of rated capacity or less.

### **Combined Heat and Power Property**

The energy credit applies to combined heat and power (“CHP”) property placed in service prior to January 1, 2017. The credit rate is 10 percent.

CHP property is property: (1) that uses the same energy source for the simultaneous or sequential generation of electrical power, mechanical shaft power, or both, in combination with the generation of steam or other forms of useful thermal energy (including heating and

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cooling applications); (2) that has an electrical capacity of not more than 50 megawatts or a mechanical energy capacity of not more than 67,000 horsepower or an equivalent combination of electrical and mechanical energy capacities; (3) that produces at least 20 percent of its total useful energy in the form of thermal energy that is not used to produce electrical or mechanical power, and produces at least 20 percent of its total useful energy in the form of electrical or mechanical power (or a combination thereof); and (4) the energy efficiency percentage of which exceeds 60 percent. CHP property does not include property used to transport the energy source to the generating facility or to distribute energy produced by the facility.

The otherwise allowable credit with respect to CHP property is reduced to the extent the property has an electrical capacity or mechanical capacity in excess of any applicable limits. Property in excess of the applicable limit (15 megawatts or a mechanical energy capacity of more than 20,000 horsepower or an equivalent combination of electrical and mechanical energy capacities) is permitted to claim a fraction of the otherwise allowable credit. The fraction is equal to the applicable limit divided by the capacity of the property. For example, a 45 megawatt property would be eligible to claim 15/45ths, or one third, of the otherwise allowable credit. Again, no credit is allowed if the property exceeds the 50 megawatt or 67,000 horsepower limitations described above.

Additionally, systems whose fuel source is at least 90 percent open-loop biomass and that would qualify for the credit but for the failure to meet the efficiency standard are eligible for a credit that is reduced in proportion to the degree to which the system fails to meet the efficiency standard. For example, a system that would otherwise be required to meet the 60-percent efficiency standard, but which only achieves 30-percent efficiency, would be permitted a credit equal to one-half of the otherwise allowable credit (i.e., a 5-percent credit).

### **Election of Energy Credit In Lieu of IRC Section 45 Production Tax Credit**

A taxpayer may make an irrevocable election to have certain qualified facilities placed in service after 2008 and whose construction begins before January 1, 2015, be treated as energy property eligible for a 30-percent investment credit under IRC section 48.<sup>215</sup> For this purpose, qualified facilities are facilities otherwise eligible for the renewable electricity production tax credit with respect to which no credit under IRC section 45 has been allowed. A taxpayer electing to treat a facility as energy property may not claim the production credit under IRC section 45.

#### New Federal Law (IRC section 48)

##### *Extension of Fiber-Optic Solar Property*

The provision extends the 30-percent energy credit for equipment that uses solar energy to illuminate the inside of a structure using fiber-optic distributed sunlight with respect to

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<sup>215</sup> See section 302 of the Act relating to an extension of the January 1, 2015, date in the case of wind facilities.

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property the construction of which begins before January 1, 2022. However, see below for the phase-out of this energy credit.

*Extension of Thermal Energy Property*

The provision extends the 10-percent energy credit for equipment which uses the ground or ground water as a thermal energy source to heat a structure or as a thermal energy sink to cool a structure, with respect to property the construction of which begins before January 1, 2022.

*Extension of Fuel Cell Property*

The provision extends the 30-percent energy credit for qualified fuel cell property, with respect to property the construction of which begins before January 1, 2022. However, see below for the phase-out of this energy credit.

*Extension of Qualified Microturbine Property*

The provision extends the 10-percent energy credit for qualified microturbine property, with respect to property the construction of which begins before January 1, 2022.

*Extension of Combined Heat and Power System Property*

The provision extends the 10-percent energy credit for combined heat and power system property, with respect to property the construction of which begins before January 1, 2022.

*Extension of Qualified Small Wind Energy Property*

The provision extends the 30-percent energy credit for qualified small wind energy property, with respect to property the construction of which begins before January 1, 2022. However, see below for the phase-out of this energy credit.

*Phase-out of 30-Percent Credit Rate for Fiber-Optic Solar, Qualified Fuel Cell, and Qualified Small Wind Energy Property*

The provision phases out the 30-percent energy credit for qualified fuel cell property, qualified small wind property, and fiber-optic solar property by reducing the credit percentage for each to 26 percent for any such property placed in service after December 31, 2019, and before January 1, 2021; and to 22 percent for any such property placed in service after December 31, 2020, and before January 1, 2022. Such property that is not placed in service before January 1, 2024, shall not be eligible for an energy credit.

Effective Dates

The phase-out of the 30-percent energy credit for qualified fuel cell property, qualified small wind property, and fiber-optic solar property is effective the date of enactment, February 9, 2018.



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The extension of combined heat and power system property is effective for property placed in service after December 31, 2016.

All other provisions are effective for periods beginning after December 31, 2016, under rules similar to IRC section 48(m) as in effect November 4, 1990.<sup>216</sup>

California Law (None)

California does not conform to the federal energy credit.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
40412	Extension of Special Allowance for Second Generation Biofuel Plant Property

Background

Present law<sup>217</sup> allows an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified second generation biofuel plant property. In order to qualify, the property generally must be placed in service before January 1, 2017.<sup>218</sup>

Qualified second generation biofuel plant property means depreciable property used in the U.S. solely to produce any liquid fuel that (1) is derived from qualified feedstocks, and (2) meets the registration requirements for fuels and fuel additives established by the Environmental Protection Agency (EPA) under section 211 of the Clean Air Act.<sup>219</sup> Qualified feedstocks means any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis<sup>220</sup> and any cultivated algae, cyanobacteria, or lemna.<sup>221</sup> Second generation biofuel does not include any alcohol with a proof of less than 150 or certain unprocessed fuel.<sup>222</sup> Unprocessed fuels are fuels that (1) are more than

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<sup>216</sup> When the application of a provision is expressed in terms of a time period, and the construction, reconstruction, or erection of that property is completed after the beginning of that period, only the portion of the basis which is properly attributable to construction, reconstruction, or erection after the beginning of that period qualifies for the credit. Also, in the case of property acquired and placed in service by the taxpayer during the period (rather than constructed by the taxpayer), only property acquired and placed in service after the beginning of that period will qualify for the credit.

<sup>217</sup> IRC section 168(l).

<sup>218</sup> IRC section 168(l)(2)(D).

<sup>219</sup> IRC sections 168(l)(2)(A) and 40(b)(6)(E).

<sup>220</sup> For example, lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis includes bagasse (from sugar cane), corn stalks, and switchgrass.

<sup>221</sup> IRC section 40(b)(6)(F).

<sup>222</sup> IRC section 40(b)(6)(E)(ii) and (iii).

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four percent (determined by weight) water and sediment in any combination, (2) have an ash content of more than one percent (determined by weight), or (3) have an acid number greater than 25.<sup>223</sup>

The additional first-year depreciation deduction is allowed for both regular tax and AMT purposes for the taxable year in which the property is placed in service.<sup>224</sup> The additional first-year depreciation deduction is subject to the general rules regarding whether an item is subject to capitalization under IRC section 263A. The basis of the property and the depreciation allowances in the year of purchase and later years are appropriately adjusted to reflect the additional first-year depreciation deduction.<sup>225</sup> In addition, there is no adjustment to the allowable amount of depreciation for purposes of computing a taxpayer's alternative minimum taxable income with respect to property to which the provision applies.<sup>226</sup>

A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.<sup>227</sup>

In order for property to qualify for the additional first-year depreciation deduction, it must meet the following requirements: (1) the original use of the property must commence with the taxpayer; and (2) the property must be (i) acquired by purchase (as defined under IRC section 179(d)) by the taxpayer, and (ii) placed in service before January 1, 2017.<sup>228</sup> Property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer qualifies if the taxpayer begins the manufacture, construction, or production of the property before January 1, 2017 (and all other requirements are met).<sup>229</sup> Property that is manufactured, constructed, or produced for the taxpayer by another person under a contract that is entered into prior to the manufacture, construction, or production of the property is considered to be manufactured, constructed, or produced by the taxpayer.

Property any portion of which is financed with the proceeds of a tax-exempt obligation under IRC section 103 is not eligible for the additional first-year depreciation deduction.<sup>230</sup>

Recapture rules apply if the property ceases to be qualified second generation biofuel plant property.<sup>231</sup>

Property with respect to which the taxpayer has elected 50-percent expensing under IRC section 179C is not eligible for the additional first-year depreciation deduction.<sup>232</sup>

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<sup>223</sup> IRC section 40(b)(6)(E)(iii).

<sup>224</sup> IRC section 168(l)(5).

<sup>225</sup> IRC section 168(l)(1)(B).

<sup>226</sup> IRC sections 168(l)(5) and (k)(2)(G).

<sup>227</sup> IRC section 168(l)(3)(D).

<sup>228</sup> IRC section 168(l)(2). Requirements relating to actions taken before 2007 are not described herein because they have little (if any) remaining effect.

<sup>229</sup> IRC section 168(l)(4) and (k)(2)(E).

<sup>230</sup> IRC section 168(l)(3)(C).

<sup>231</sup> IRC section 168(l)(6).

<sup>232</sup> IRC section 168(l)(7).

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New Federal Law (IRC section 168)

The provision extends the present-law special depreciation allowance for one year, to qualified second generation biofuel plant property placed in service prior to January 1, 2018.

Effective Date

The provision applies to property placed in service after December 31, 2016.

California Law (R&TC sections 17201 and 17250)

This provision is not applicable under California law.

The PITL specifically does not conform to the special allowance for cellulosic biofuel plant property,<sup>233</sup> and that special allowance has not been adopted under the CTL.<sup>234</sup>

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
40413	Extension of Energy Efficient Commercial Buildings Deduction

Background

**In General**

IRC section 179D provides an election under which a taxpayer may take an immediate deduction equal to energy-efficient commercial building property expenditures made by the taxpayer. Energy-efficient commercial building property is defined as property (1) which is installed on or in any building located in the United States that is within the scope of Standard 90.1-2001 of the American Society of Heating, Refrigerating, and Air Conditioning Engineers and the Illuminating Engineering Society of North America (“ASHRAE/IESNA”), (2) which is installed as part of (i) the interior lighting systems, (ii) the heating, cooling, ventilation, and hot water systems, or (iii) the building envelope, and (3) which is certified as being installed as part of a plan designed to reduce the total annual energy and power costs with respect to the interior lighting systems, heating, cooling, ventilation, and hot water

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<sup>233</sup> The PITL generally conforms to MACRS provisions of IRC section 168 under R&TC section 17201 as of the specified date of January 1, 2015, but specifically does not conform to the special allowance for cellulosic biofuel plant property under R&TC section 17250(a)(2)(C)(8).

<sup>234</sup> The CTR does not adopt the MACRS provisions of IRC section 168, and instead is generally in substantial conformity to the pre-1981 federal ADR rules that generally allow property to be depreciated based on its useful life under R&TC section 24349.

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systems of the building by 50 percent or more in comparison to a reference building which meets the minimum requirements of Standard 90.1-2001 (as in effect on April 2, 2003). The deduction is limited to an amount equal to \$1.80 per square foot of the property for which such expenditures are made. The deduction is allowed in the year in which the property is placed in service.

Certain certification requirements must be met in order to qualify for the deduction. The Secretary, in consultation with the Secretary of Energy, will promulgate regulations that describe methods of calculating and verifying energy and power costs using qualified computer software based on the provisions of the 2005 California Nonresidential Alternative Calculation Method Approval Manual or, in the case of residential property, the 2005 California Residential Alternative Calculation Method Approval Manual.

The Secretary is granted authority to prescribe procedures for the inspection and testing for compliance of buildings that are comparable, given the difference between commercial and residential buildings, to the requirements in the Mortgage Industry National Accreditation Procedures for Home Energy Rating Systems.<sup>235</sup> Individuals qualified to determine compliance shall only be those recognized by one or more organizations certified by the Secretary for such purposes.

For energy-efficient commercial building property expenditures made by a public entity, such as public schools, the deduction may be allocated to the person primarily responsible for designing the property in lieu of the public entity.

If a deduction is allowed under this section, the basis of the property is reduced by the amount of the deduction.

The deduction is effective for property placed in service prior to January 1, 2017.

### **Partial Allowance of Deduction**

#### *System-Specific Deductions*

In the case of a building that does not meet the overall building requirement of 50-percent energy savings, a partial deduction is allowed with respect to each separate building system that comprises energy efficient property and which is certified by a qualified professional as meeting or exceeding the applicable system-specific savings targets established by the Secretary. The applicable system-specific savings targets to be established by the Secretary are those that would result in a total annual energy savings with respect to the whole building of 50 percent, if each of the separate systems met the system specific target. The separate building systems are (1) the interior lighting system, (2) the heating, cooling, ventilation and hot water systems, and (3) the building envelope. The maximum allowable deduction is \$0.60 per square foot for each separate system.

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<sup>235</sup> See IRS Notice 2006-52, 2006-1 C.B. 1175, June 2, 2006; IRS 2008-40, 2008-14 I.R.B. 725, March 11, 2008.

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*Interim Rules for Lighting Systems*

In general, in the case of system-specific partial deductions, no deduction is allowed until the Secretary establishes system-specific targets.<sup>236</sup> However, in the case of lighting system retrofits, until such time as the Secretary issues final regulations, the system-specific energy savings target for the lighting system is deemed to be met by a reduction in lighting power density of 40 percent (50 percent in the case of a warehouse) of the minimum requirements in Table 9.3.1.1 or Table 9.3.1.2 of ASHRAE/IESNA Standard 90.1-2001. Also, in the case of a lighting system that reduces lighting power density by 25 percent, a partial deduction of 30 cents per square foot is allowed. A pro-rated partial deduction is allowed in the case of a lighting system that reduces lighting power density between 25 percent and 40 percent. Certain lighting-level and lighting-control requirements must also be met in order to qualify for the partial lighting deductions under the interim rule.

New Federal Law (IRC section 179D)

The provision extends the deduction for one year, through December 31, 2017.

Effective Date

The provision applies to property placed in service after December 31, 2016.

California Law (R&TC sections 17255, 17257.2 and 24356)

This provision is not applicable under California Law.

Under the PITL, California specifically does not conform to the federal election to expense energy efficient commercial buildings,<sup>237</sup> and the election has not been adopted under the CTL.

Under both the PITL and the CTL, as it relates to the election to deduct (or “expense”) costs in lieu of depreciation, California conforms to IRC section 179, with significant modifications.<sup>238</sup> Taxpayers with a sufficiently small amount of annual investment may elect to deduct up to \$25,000 of the cost of qualifying property placed in service for the taxable year. The \$25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000. The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined

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<sup>236</sup> IRS Notice 2008-40, *Supra*, set a target of a 10-percent reduction in total energy and power costs with respect to the building envelope, and 20 percent each with respect to the interior lighting system and the heating, cooling, ventilation and hot water systems. IRS Notice 2012-26 (2012-17 I.R.B. 847 April 23, 2012) established new targets of 10-percent reduction in total energy and power costs with respect to the building envelope, 25 percent with respect to the interior lighting system and 15 percent with respect to the heating, cooling, ventilation and hot water systems, effective beginning March 12, 2012. The targets from Notice 2008-40 may be used until December 31, 2013, but the targets of Notice 2012-26 apply thereafter.

<sup>237</sup> R&TC section 17257.2.

<sup>238</sup> R&TC sections 17255 and 24356.

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without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations.).

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
40414	Extension of Special Rule for Sales or Dispositions to Implement FERC or State Electric Restructuring Policy for Qualified Electric Utilities

Background

A taxpayer selling property generally realizes gain to the extent the sales price (and any other consideration received) exceeds the taxpayer's basis in the property.<sup>239</sup> The realized gain is subject to current income tax<sup>240</sup> unless the recognition of the gain is deferred or excluded from income under a special tax provision.<sup>241</sup>

One such special tax provision permits taxpayers to elect to recognize gain from qualifying electric transmission transactions ratably over an eight-year period beginning in the year of sale if the amount realized from such sale is used to purchase exempt utility property within the applicable period<sup>242</sup> (the "reinvestment property").<sup>243</sup> If the amount realized exceeds the amount used to purchase reinvestment property, any realized gain is recognized to the extent of such excess in the year of the qualifying electric transmission transaction.

A qualifying electric transmission transaction is the sale or other disposition of property used by a qualified electric utility to an independent transmission company prior to January 1, 2015.<sup>244</sup> A qualified electric utility is defined as an electric utility, which as of the date of the qualifying electric transmission transaction, is vertically integrated in that it is both (1) a transmitting utility (as defined in the Federal Power Act<sup>245</sup>) with respect to the

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<sup>239</sup> See IRC section 1001.

<sup>240</sup> See IRC sections 61 and 451.

<sup>241</sup> See, e.g., IRC sections 453, 1031 and 1033.

<sup>242</sup> The applicable period for a taxpayer to reinvest the proceeds is four years after the close of the taxable year in which the qualifying electric transmission transaction occurs.

<sup>243</sup> IRC section 451(i).

<sup>244</sup> IRC section 451(i)(3).

<sup>245</sup> Section 3(23), 16 U.S.C. section 796, defines "transmitting utility" as any electric utility, qualifying cogeneration facility, qualifying small power production facility, or Federal power marketing agency that owns or operates electric power transmission facilities that are used for the sale of electric energy at wholesale.

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transmission facilities to which the election applies, and (2) an electric utility (as defined in the Federal Power Act<sup>246</sup>).<sup>247</sup>

In general, an independent transmission company is defined as: (1) an independent transmission provider<sup>248</sup> approved by the Federal Energy Regulatory Commission (FERC); (2) a person (i) who the FERC determines under section 203 of the Federal Power Act<sup>249</sup> (or by declaratory order) is not a “market participant” and (ii) whose transmission facilities are placed under the operational control of a FERC-approved independent transmission provider no later than four years after the close of the taxable year in which the transaction occurs; or (3) in the case of facilities subject to the jurisdiction of the Public Utility Commission of Texas, (i) a person which is approved by that Commission as consistent with Texas state law regarding an independent transmission organization, or (ii) a political subdivision, or affiliate thereof, whose transmission facilities are under the operational control of an organization described in (i).<sup>250</sup>

Exempt utility property is defined as: (1) property used in the trade or business of (i) generating, transmitting, distributing, or selling electricity or (ii) producing, transmitting, distributing, or selling natural gas; or (2) stock in a controlled corporation whose principal trade or business consists of the activities described in (1).<sup>251</sup> Exempt utility property does not include any property that is located outside of the United States.<sup>252</sup>

If a taxpayer is a member of an affiliated group of corporations filing a consolidated return, the reinvestment property may be purchased by any member of the affiliated group (in lieu of the taxpayer).<sup>253</sup>

### **The Tax Cuts and Jobs Act (TCJA)<sup>254</sup> Provision Related to IRC Section 451**

The TCJA provision revises the rules associated with the timing of the recognition of income.<sup>255</sup> Specifically, the TCJA provision requires an accrual method taxpayer subject to

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<sup>246</sup> Section 3(22), 16 U.S.C. section 796, defines “electric utility” as any person or State agency (including any municipality) that sells electric energy; such term includes the Tennessee Valley Authority, but does not include any federal power marketing agency.

<sup>247</sup> IRC section 451(i)(6).

<sup>248</sup> For example, a regional transmission organization, an independent system operator, or an independent transmission company.

<sup>249</sup> 16 U.S.C. section 824b.

<sup>250</sup> IRC section 451(i)(4).

<sup>251</sup> IRC section 451(i)(5).

<sup>252</sup> IRC section 451(i)(5)(C).

<sup>253</sup> IRC section 451(i)(7).

<sup>254</sup> Public Law 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, Section 13221, enacted December 22, 2017.

<sup>255</sup> The TCJA 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 TCJA 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 TCJA 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



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the all events test for an item of gross income to recognize such income no later than the taxable year in which such income is taken into account as revenue in an applicable financial statement<sup>256</sup> or another financial statement under rules specified by the Secretary, but provides an exception for taxpayers without an applicable or other specified financial statement.<sup>257</sup> In the case of a contract which contains multiple performance obligations, the TCJA allows the taxpayer to allocate the transaction price in accordance with the allocation made in the taxpayer's applicable financial statement.

In addition, the TCJA 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 original issue discount (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.<sup>258</sup> 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

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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).

<sup>256</sup> For purposes of the TCJA, 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.

<sup>257</sup> Congress intends that the TCJA 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 TCJA, 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 TCJA, 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).

<sup>258</sup> IRC sections 1271-1288.

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accordance with the general recognition principles under IRC section 451. The TCJA provision provides an exception for any item of gross income in connection with a mortgage servicing contract. Thus, under the TCJA 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 the all events test of IRC section 451 (*i.e.*, not averaged over the life of the mortgage),<sup>259</sup> and “excess” mortgage servicing rights will be treated as stripped coupons under IRC section 1286 and therefore subject to the original issue discount rules.)<sup>260</sup>

The TCJA 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.<sup>261</sup> That is, the TCJA provision allows accrual method taxpayers to elect<sup>262</sup> 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.<sup>263</sup> In the case of advance payments received for a combination of services, goods, or other specified items, the TCJA provision allows the taxpayer to allocate the transaction price in accordance with the allocation made in the taxpayer's applicable financial statement. The TCJA 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 TCJA 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.

#### New Federal Law (IRC section 451)

The provision extends for one year the treatment under the present-law deferral provision to sales or dispositions by a qualified electric utility that occur prior to January 1, 2018.

#### Effective Date

The provision applies to dispositions after December 31, 2016.

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<sup>259</sup> See Revenue Ruling 70-142, 1970-2 C.B. 115.

<sup>260</sup> See Revenue Ruling 91-46, 1991-2, C.B. 358, and Revenue Procedure 91-50, 1991-2 C.B. 778.

<sup>261</sup> 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.

<sup>262</sup> 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.

<sup>263</sup> Thus, the TCJA is intended to override any deferral method provided by Treasury Regulation section 1.451-5 for advance payments received for goods.

California Law (R&TC sections 17551, 24661, and 24661.6)

This provision is not applicable under California law.

The PITL and the CTL generally conform to the federal rules relating to the taxable year of inclusion;<sup>264</sup> however, both the PITL and the CTL specifically do not conform to the special rule for sales or dispositions to implement FERC or state electric restructuring policy.<sup>265</sup>

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
40415	Extension of Excise Tax Credits Relating to Alternative Fuels

Background

**Alternative Fuel and Alternative Fuel Mixture Credits and Payments**

The IRC provides two per-gallon excise tax credits with respect to alternative fuel: the alternative fuel credit, and the alternative fuel mixture credit. For this purpose, the term “alternative fuel” means liquefied petroleum gas, P Series fuels (as defined by the Secretary of Energy under 42 U.S.C. section 13211(2)), compressed or liquefied natural gas, liquefied hydrogen, liquid fuel derived from coal through the Fischer-Tropsch process (“coal-to-liquids”), compressed or liquefied gas derived from biomass, or liquid fuel derived from biomass. Such term does not include ethanol, methanol, or biodiesel.

For coal-to-liquids produced after December 30, 2009, the fuel must be certified as having been derived from coal produced at a gasification facility that separates and sequesters 75 percent of such facility’s total carbon dioxide emissions.

The alternative fuel credit is allowed against IRC section 4041 liability, and the alternative fuel mixture credit is allowed against IRC section 4081 liability. Neither credit is allowed unless the taxpayer is registered with the Secretary. The alternative fuel credit is 50 cents per gallon of alternative fuel or gasoline gallon equivalents<sup>266</sup> of non-liquid alternative fuel

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<sup>264</sup> Under the PITL, R&TC section 17551 conforms to Subchapter E of Chapter 1 of Subtitle A of the IRC, containing IRC sections 441-483, as of the specified date of January 1, 2015, with modifications. Under the CTR, R&TC section 24661 conforms to IRC section 451, relating to the general rule for taxable year of inclusion, as of the specified date of January 1, 2015.

<sup>265</sup> R&TC sections 17551(f) and 24661.6.

<sup>266</sup> “Gasoline gallon equivalent” means, with respect to any non-liquid alternative fuel (for example, compressed natural gas), the amount of such fuel having a Btu (British thermal unit) content of 124,800 (higher heating value).

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sold by the taxpayer for use as a motor fuel in a motor vehicle or motorboat, sold for use in aviation or so used by the taxpayer.

The alternative fuel mixture credit is 50 cents per gallon of alternative fuel used in producing an alternative fuel mixture for sale or use in a trade or business of the taxpayer. An “alternative fuel mixture” is a mixture of alternative fuel and taxable fuel (gasoline, diesel fuel or kerosene) that contains at least 1/10 of one percent taxable fuel. The mixture must be sold by the taxpayer producing such mixture to any person for use as a fuel, or used by the taxpayer producing the mixture as a fuel. The credits expired after December 31, 2016.

A person may file a claim for payment equal to the amount of the alternative fuel credit (but not the alternative fuel mixture credit). The alternative fuel credit must first be applied to the applicable excise tax liability under IRC section 4041 or 4081, and any excess credit may be taken as a payment. These payment provisions generally also expire after December 31, 2016.

For purposes of the alternative fuel credit, alternative fuel mixture credit and related payment provisions, “alternative fuel” does not include fuel (including lignin, wood residues, or spent pulping liquors) derived from the production of paper or pulp.

New Federal Law (IRC sections 6426 and 6427)

The provision extends the alternative fuel credit and related payment provisions, and the alternative fuel mixture credit, through December 31, 2017.<sup>267</sup>

In light of the retroactive nature of the provision, as it relates to alternative fuel sold or used in 2017, the provision creates a special rule to address claims regarding excise credits and claims for payment for the period beginning January 1, 2017, and ending on December 31, 2017.

In particular, the provision directs the Secretary to issue guidance within 30 days of the date of enactment. Such guidance is to provide for a one-time submission of claims covering periods occurring during 2017. The guidance is to provide for a 180-day period for the submission of such claims (in such manner as prescribed by the Secretary) to begin no later than 30 days after such guidance is issued.<sup>268</sup> Such claims shall be paid by the Secretary not later than 60 days after receipt. If the claim is not paid within 60 days of the date of the filing, the claim shall be paid with interest from such date determined by using the overpayment rate and method under IRC section 6621.

Effective Date

The provision is effective for property purchased after December 31, 2016.

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<sup>267</sup> See section 342 of this Act with respect to additional provisions related to liquefied petroleum gas and liquefied natural gas.

<sup>268</sup> This guidance is provided by Notice 2015-3, 2015-6 I.R.B 583.

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.

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<u>Section</u>	<u>Section Title</u>
40416	Increase and Extension of Oil Spill Liability Trust Fund

Background

The Oil Spill Liability Trust Fund financing rate (“oil spill tax”) was reinstated effective April 1, 2006.<sup>269</sup> The oil spill tax rate is five cents per barrel and generally applies to crude oil received at a U.S. refinery and to petroleum products entered into the United States for consumption, use, or warehousing.<sup>270</sup>

The oil spill tax also applies to certain uses and the exportation of domestic crude oil.<sup>271</sup> If any domestic crude oil is used in or exported from the United States, and before such use or exportation no oil spill tax was imposed on such crude oil, then the oil spill tax is imposed on such crude oil. The tax does not apply to any use of crude oil for extracting oil or natural gas on the premises where such crude oil was produced.

For crude oil received at a refinery, the operator of the U.S. refinery is liable for the tax. For imported petroleum products, the person entering the product for consumption, use, or warehousing is liable for the tax. For certain uses and exports, the person using or exporting the crude oil is liable for the tax. No tax is imposed with respect to any petroleum product if the person who would be liable for such tax establishes that a prior oil spill tax has been imposed with respect to such product.

The imposition of the tax is dependent in part on the balance of the Oil Spill Liability Trust Fund. If the Secretary estimates that the un-obligated balance in the Oil Spill Liability Trust Fund is less than \$2 billion at the close of any calendar quarter, the oil spill tax will apply on the date that is 30 days from the last day of that quarter. The tax does not apply to any periods after December 31, 2017.

The tax rate is eight cents per barrel for the first quarter that is more than 60 days after October 3, 2008, through December 31, 2016, and then increases to nine cents per barrel for calendar year 2017.

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<sup>269</sup> IRC section 4611(f).

<sup>270</sup> The term “crude oil” includes crude oil condensates and natural gasoline. The term “petroleum product” includes crude oil.

<sup>271</sup> The term “domestic crude oil” means any crude oil produced from a well located in the United States.

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New Federal Law (IRC section 4611)

The provision extends the oil spill tax through December 31, 2018.

Effective Date

The provision is effective on or after the first day of the first calendar month beginning after the February 9, 2018, date of enactment.

California Law (None)

The FTB does not administer these types of excise taxes.

Impact on California Revenue

The FTB does not administer these types of excise taxes.

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**Subtitle D—Modifications of Energy Incentives**

<u>Section</u>	<u>Section Title</u>
40501	Modifications of Credit for Production from Advanced Nuclear Power Facilities

Background

Current law permits a taxpayer producing electricity at a qualifying advanced nuclear power facility to claim a credit equal to 1.8 cents per kilowatt-hour of electricity produced for the eight-year period starting when the facility is placed in service.<sup>272</sup> The aggregate amount of credit that a taxpayer may claim in any year during the eight-year period is subject to limitation based on allocated capacity and an annual limitation as described below.

A qualifying advanced nuclear facility is an advanced nuclear facility for which the taxpayer has received an allocation of megawatt capacity from the Secretary and is placed in service before January 1, 2021. The taxpayer may only claim credit for production of electricity equal to the ratio of the allocated capacity that the taxpayer receives from the Secretary to the rated nameplate capacity of the taxpayer's facility. For example, if the taxpayer receives an allocation of 750 megawatts of capacity from the Secretary and the taxpayer's facility has a rated nameplate capacity of 1,000 megawatts, then the taxpayer may claim three-quarters of the otherwise allowable credit, or 1.35 cents per kilowatt-hour, for each kilowatt-

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<sup>272</sup> The 1.8-cents credit amount is reduced, but not below zero, if the annual average contract price per kilowatt-hour of electricity generated from advanced nuclear power facilities in the preceding year exceeds eight cents per kilowatt-hour. The eight-cent price comparison level is indexed for inflation after 1992, with the phase-out indexed for inflation but not the credit rate.

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hour of electricity produced at the facility (subject to the annual limitation described below). The Secretary may allocate up to 6,000 megawatts of capacity.

A taxpayer operating a qualified facility may claim no more than \$125 million in tax credits per 1,000 megawatts of allocated capacity in any one year of the eight-year credit period. If the taxpayer operates a 1,350 megawatt rated nameplate capacity system and has received an allocation from the Secretary for 1,350 megawatts of capacity eligible for the credit, the taxpayer's annual limitation on credits that may be claimed is equal to 1.35 times \$125 million, or \$168.75 million. If the taxpayer operates a facility with a nameplate rated capacity of 1,350 megawatts, but has received an allocation from the Secretary for 750 megawatts of credit eligible capacity, then the two limitations apply such that the taxpayer may claim a credit equal to 1.35 cents per kilowatt-hour of electricity produced (as described above) subject to an annual credit limitation of \$93.75 million in credits (three-quarters of \$125 million).

An advanced nuclear facility is any nuclear facility for the production of electricity, the reactor design for which was approved after 1993 by the Nuclear Regulatory Commission. For this purpose, a qualifying advanced nuclear facility does not include any facility for which a substantially similar design for a facility of comparable capacity was approved before 1994. In addition, the credit allowable to the taxpayer is reduced by reason of grants, tax exempt bonds, subsidized energy financing, and other credits, but such reduction cannot exceed 50 percent of the otherwise allowable credit. The credit is treated as part of the general business credit.

New Federal Law (IRC section 45J)

*Treatment of Unutilized Limitation Amounts*

The provision specifies that any unutilized national megawatt capacity limitation shall be allocated by the IRS as rapidly as practicable after Dec. 31, 2020 as follows:

- First to facilities placed in service before January 1, 2021 to the extent that those facilities did not receive an allocation equal to their full nameplate capacity, and
- Then to facilities placed in service after December 31, 2020 in the order in which those facilities are placed in service.<sup>273</sup>

Unutilized national megawatt capacity limitation is defined as the excess, if any, of 6,000 megawatts over the aggregate amount of national megawatt capacity limitation allocated by the IRS before January 1, 2021, reduced by any amount of that limitation which was allocated to a facility that had not been placed in service before such date.<sup>274</sup>

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<sup>273</sup> IRC section 45J(b)(5)(A).

<sup>274</sup> IRC section 45J(b)(5)(B).



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Any unutilized national megawatt capacity limitation allocated by the IRS under this provision is treated in the same manner as an allocation of national megawatt capacity limitation, and IRC section 45J(d)(1)(B) doesn't apply to any facility which receives such an allocation.<sup>275</sup>

Not later than six months after February 9, 2018, the IRS must prescribe regulations to describe how to allocate any unutilized national megawatt capacity limitation. The regulations must provide a certification process under which the IRS, after consultation with the Secretary of Energy, is to approve and allocate the national megawatt capacity limitation.

*Transfer of Credit by Certain Public Entities*

For taxable years that begin after the enactment date, February 9, 2018, the provision specifies that if, but for this provision, a qualified public entity would otherwise be the taxpayer, it can elect to transfer all or any portion specified in the election of the advanced nuclear power facility production credit to an eligible project partner, and the project partner specified in the election, and not the qualified public entity, will be allowed the credit.<sup>276</sup>

A qualified public entity is defined as the following:

- A federal, state, or local government entity, or any political subdivision, agency, or instrumentality thereof.
- A mutual or cooperative electric company.<sup>277</sup>
- A not-for-profit electric utility which had or has received a loan or loan guarantee under the Rural Electrification Act of 1936.<sup>278</sup>

An eligible project partner is defined as any person that:

- Is responsible for, or participates in, the design or construction of the advanced nuclear power facility to which the advanced nuclear power facility production relates,
- Participates in the provision of the nuclear steam supply system to the facility,
- Participates in the provision of nuclear fuel to the facility,
- Is a financial institution providing financing for the construction or operation of the facility, and
- Has an ownership interest in the facility.<sup>279</sup>

If an advanced nuclear power facility production credit is determined at the partnership level, a qualified public entity is treated as the taxpayer with respect to the partnership's

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<sup>275</sup> IRC section 45J(b)(5)(C).

<sup>276</sup> IRC section 45J(e)(1).

<sup>277</sup> IRC section 501(c)(12) and 1381(a)(2).

<sup>278</sup> IRC section 45J(e)(2)(A).

<sup>279</sup> IRC section 45J(e)(2)(B).

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distributive share of the credit, and an eligible project partner includes any partner of the partnership.<sup>280</sup>

In the case of any credit or portion of a credit that has been transferred to an eligible project partner, the credit must be taken into account in the first tax year of the eligible project partner ending with, or after, the tax year of the qualified public entity with respect to which the credit was determined.<sup>281</sup>

Any benefit derived by an eligible project partner in connection with an election to transfer an advanced nuclear power facility production credit is not be taken into account under IRC section 141(b)(1) as private business use.<sup>282</sup>

Income received or accrued by a mutual or cooperative electric company or by certain corporations operating on a cooperative basis, in connection with an election to transfer an advanced nuclear power facility production credit, is treated as an amount collected from members for the sole purpose of meeting losses and expenses.<sup>283</sup>

### Effective Dates

The provision related to the treatment of unutilized limitation amounts is effective on the enactment date, February 9, 2018. The provision related to the transfer of credit by certain public entities is effective for taxable years beginning after the date of enactment, February 9, 2018.

### California Law (None)

California does not conform to the credit for production from advanced nuclear power facilities.

### Impact on California Revenue

Not applicable.

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## Title II—Miscellaneous Provisions

<u>Section</u>	<u>Section Title</u>
41102	Modifications to Rum Cover Over

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<sup>280</sup> IRC section 45J(e)(3)(A).

<sup>281</sup> IRC section 45J(e)(3)(B).

<sup>282</sup> IRC section 45J(e)(3)(C).

<sup>283</sup> IRC section 501(c)(12)(I).

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Background

An excise tax is imposed on all distilled spirits produced in, or imported into, the United States.<sup>284</sup> 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.<sup>285</sup>

Distilled spirits are taxed at a rate of \$13.50 per proof gallon.<sup>286</sup> 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 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.

A portion of the revenues from the distilled spirits excise tax imposed on rum imported or brought into<sup>287</sup> the United States (less certain administrative costs) is transferred (“covered over”) to Puerto Rico and the U.S. Virgin Islands.<sup>288</sup> 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).

During the period from January 1, 2018, through December 31, 2019, the amount covered over 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. 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.<sup>289</sup>

New Federal Law (IRC section 7652)

The provision suspends for five years the \$10.50 per proof gallon limitation on the amount of excise taxes on rum covered over to Puerto Rico and the Virgin Islands. Under the provision, the cover over limitation of \$13.25 per proof gallon is extended for rum brought into the United States after December 31, 2016, and before January 1, 2022. After December 31, 2021, the cover over amount reverts to \$10.50 per proof gallon.

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<sup>284</sup> IRC section 5001.

<sup>285</sup> 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.

<sup>286</sup> 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.

<sup>287</sup> 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.

<sup>288</sup> IRC section 7652.

<sup>289</sup> IRC section 5011. IRC section 5011 is administered and enforced by the IRS.

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The provision also specifies that the tiered excise tax rates do not apply after December 31, 2017.

Effective Date

The provision is effective for distilled spirits brought into the United States after December 31, 2016.

The provision making the tiered excise tax rate inapplicable is effective for distilled spirits brought into the United State 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.

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<u>Section</u>	<u>Section Title</u>
41103	Extension of Waiver of Limitations with Respect to Excluding from Gross Income Amounts Received by Wrongfully Incarcerated Individuals

Background

The taxability of damages, *i.e.*, the amounts received as a result of a claim or legal action for compensation for injury, depends upon the nature of the underlying claim. If a direct payment on the underlying claim would be includible as income under IRC section 61, and no specific exemption for that type of income is otherwise provided in the IRC, then damages intended to compensate for loss of that includible income are themselves includible income.<sup>290</sup>

IRC section 104 specifically excludes from gross income most compensation for personal physical injuries or physical sickness. Damages for non-physical injuries, such as mental anguish, damage to reputation, discrimination, or lost income, are not within the purview of the IRC section 104 exclusion. Compensation related to wrongful incarceration but not personal physical injuries or physical sickness is not specifically addressed by the IRC.

IRC section 139F provides that with respect to any wrongfully incarcerated individual, gross income shall not include any civil damages, restitution, or other monetary award (including

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<sup>290</sup> For example, a claim for lost wages results in taxable damages, because the wages themselves would have been taxable, but an award for damage to property may not result in includible income if the award does not exceed the recipient's basis in the property.

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compensatory or statutory damages and restitution imposed in a criminal matter) relating to the incarceration of such individual for the covered offense for which such individual was convicted.

A wrongfully incarcerated individual means an individual: (1) who was convicted of a covered offense; (2) who served all or part of a sentence of imprisonment relating to that covered offense; and was pardoned, granted clemency, or granted amnesty for such offense because the individual was innocent; and (3) (i) was pardoned, granted clemency, or granted amnesty for such offense because the individual was innocent, or (ii) for whom the judgment of conviction for the offense was reversed or vacated, and whom the indictment, information, or other accusatory instrument for that covered offense was dismissed or who was found not guilty at a new trial after the judgment of conviction for that covered offense was reversed or vacated.

For these purposes, a covered offense is any criminal offense under federal or state law, and includes any criminal offense arising from the same course of conduct as that criminal offense.

The Consolidated Appropriations Act, 2016,<sup>291</sup> which added IRC section 139F, contains a special rule allowing individuals to make a claim for credit or refund of any overpayment of tax resulting from the exclusion, even if such claim would be disallowed under the IRC or by operation of any law or rule of law (including *res judicata*), if the claim for credit or refund is filed before the close of the one-year period beginning on December 18, 2015.

New Federal Law (IRC section 139F)

The provision modifies the a special rule which allows individuals to make a claim for credit or refund of any overpayment of tax resulting from the exclusion, even if such claim would be disallowed under the IRC or by operation of any law or rule of law (including *res judicata*) to apply if the claim for credit or refund is filed before the close of the three-year period<sup>292</sup> beginning on December 18, 2015.

Effective Date

The provision is effective on the date of enactment, February 9, 2018.

California Law (R&TC sections 17071, 17131, 17156.1, and 17157)

Under the PITL, California generally conforms to amounts includible in gross income under IRC section 61,<sup>293</sup> and generally conforms to federal exclusions provided in Part III of Subchapter B of Chapter 1 of the IRC, Items Specifically Excluded from Gross Income (commencing with IRC section 101), as of the specified date of conformity of

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<sup>291</sup> Public Law 113-114, Division Q, Section 304(d), enacted December 18, 2015.

<sup>292</sup> This provision extended the credit or refund filing period from a one-year to a three-year period.

<sup>293</sup> R&TC section 17071.

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January 1, 2015.<sup>294</sup> California conforms to the exclusion for wrongfully incarcerated individuals under newly-added IRC section 139F,<sup>295</sup> but does not conform to the federal extension of the credit or refund filing period.

California has stand-alone state law that provides an exclusion from gross income for any amount received in any taxable year by a claimant pursuant to Section 4904 of the California Penal Code,<sup>296</sup> meaning California law excludes only state appropriations made pursuant to that section, and no other civil damages, restitution, or other monetary award (including compensatory or statutory damages and restitution imposed in a criminal matter) relating to an individual's wrongful incarceration.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
41104	Individuals Held Harmless on Improper Levy on Retirement Plans

Background

The IRS is authorized to return property that has been wrongfully levied upon.<sup>297</sup> In general, monetary proceeds from the sale of levied property may be returned within two years of the date of the levy.

New Federal Law (IRC sections 6343)

If the IRS determines that an individual's account or benefit under an eligible retirement plan has been levied on improperly as described in IRC section 6343(b) or the levy was premature or otherwise not in accordance with IRS administrative procedures under IRC section 6343(d)(2) and property or money is returned to the individual, the individual may recontribute the amount returned and any interest paid on the money. The recontribution

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<sup>294</sup> R&TC section 17024.5.

<sup>295</sup> R&TC section 17156.1.

<sup>296</sup> R&TC section 17157 provides that gross income does not include any amount received in any taxable year by a claimant pursuant to Section 4904 of the Penal Code. Section 4904 of the Penal Code provides "If the evidence shows that the crime with which the claimant was charged was either not committed at all, or, if committed, was not committed by the claimant, and that the claimant has sustained injury through his or her erroneous conviction and imprisonment, the California Victim Compensation and Government Claims Board shall report the facts of the case and its conclusions to the next Legislature, with a recommendation that the Legislature make an appropriation for the purpose of indemnifying the claimant for the injury. The amount of the appropriation recommended shall be a sum equivalent to one hundred forty dollars (\$140) per day of incarceration served, and shall include any time spent in custody, including in a county jail, that is considered to be part of the term of incarceration. That appropriation shall not be treated as gross income to the recipient under the Revenue and Taxation Code."

<sup>297</sup> IRC section 6343.

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may be made to the eligible employer-sponsored plan, if permitted by the plan, or into an individual retirement plan (other than an endowment contract) to which a rollover contribution of a distribution from the eligible retirement plan is permitted, but only if the contribution is made not later than the original due date for filing the tax return for the taxable year in which the property or money is returned.<sup>298</sup>

At the time the property or money is returned, the IRS must notify the individual that a recontribution may be made under these provisions.<sup>299</sup>

The distribution of the improper levy and any recontribution are treated as if they were rollovers described under certain eligible retirement plans,<sup>300</sup> except that the contribution is treated as having been made for the taxable year in which the distribution of the improper levy occurred, and any interest paid is treated as earnings within the plan and is not included in gross income.<sup>301</sup>

For purposes of any recontribution neither the one-year waiting period between rollovers,<sup>302</sup> nor the prohibition on rollovers of inherited IRAs or individual retirement annuities, apply.<sup>303</sup>

If any amount is included in gross income for a taxable year by reason of a distribution due to a wrongful levy and any portion of that amount is treated as a rollover contribution under these provisions, any income tax imposed on that portion shall not be assessed, and if assessed shall be abated, and if collected shall be credited or refunded as an overpayment made on the due date for filing the return for that tax year.<sup>304</sup> However, this rule doesn't apply to a rollover contribution made from an eligible retirement plan that isn't a Roth IRA or a designated Roth account to a Roth IRA or a designated Roth account under an eligible retirement plan.<sup>305</sup> Despite the IRC section 6343(d) rule that generally bars the payment of interest on the return of property wrongfully levied on, interest will be allowed under IRC section 6343(c) where the IRS finds that a levy on an individual retirement plan was premature or otherwise not in accordance with IRS administrative procedures.<sup>306</sup>

### Effective Dates

The provision is effective for taxable years beginning on or after January 1, 2018.

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<sup>298</sup> IRC section 6343(f)(1)(A).

<sup>299</sup> IRC section 6343(f)(1)(B).

<sup>300</sup> IRC sections 402(c), 402A(c)(3), 403(a)(4), 403(b)(8), 408(d)(3), 408A(d)(3), and 457(e)(16).

<sup>301</sup> IRC section 6343(f)(2)(A).

<sup>302</sup> IRC section 408(d)(3)(B).

<sup>303</sup> IRC sections 6343(f)(2)(B) and 6343(f)(5).

<sup>304</sup> IRC section 6343(f)(3)(A).

<sup>305</sup> IRC section 6343(f)(3)(B).

<sup>306</sup> IRC section 6343(f)(4).



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California Law (California Code of Civil Procedure (CCP) sections 700.010-704.995; R&TC sections 17501, 17551, 18675, 19231-19236, 21016, 21018, and 24601)

California does not conform to IRC section 6343. Thus, the federal two year period for returning the monetary proceeds from the sale of property that has been wrongfully levied upon is 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.<sup>307 308</sup>

#### Qualified Retirement Plans

California automatically adopts changes made to IRC sections 402, 403, 408, and 457, relating to qualified retirement plans.<sup>309</sup> However, since no changes to these IRC sections were made, the provision has no impact to the California income tax treatment of qualified retirement plans.

#### Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
41105	Modification of User Fee Requirements for Installment Agreements

#### Background

The IRC authorizes the IRS to enter into written agreements with any taxpayer under which the taxpayer is allowed to pay taxes owed, as well as interest and penalties, in installment payments if the IRS determines that doing so will facilitate collection of the amounts owed (IRC section 6159). An installment agreement does not reduce the amount of taxes, interest, or penalties owed. Generally, during the period installment payments are being made, other IRS enforcement actions (such as levies or seizures) with respect to the taxes included in that agreement are held in abeyance.

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<sup>307</sup> R&TC section 21016.

<sup>308</sup> R&TC section 21018.

<sup>309</sup> R&TC sections 17501, 17551, and 24601.

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The IRS is authorized to enter into installment agreements with taxpayers that do not provide for full payment of the taxpayer's liability over the life of the agreement. The IRS is required to review partial payment installment agreements at least every two years. The primary purpose of this review is to determine whether the financial condition of the taxpayer has significantly changed so as to warrant an increase in the value of the payments being made.

The Independent Offices Appropriations Act of 1952 (IOAA),<sup>310</sup> authorizes agencies to prescribe regulations that establish user fees for services provided by the agency. The charges must be fair and must be based on the costs to the government, the value of the service to the recipient, the public policy or interest served, and other relevant facts. The IOAA provides that regulations implementing user fees are subject to policies prescribed by the President; these policies are set forth in the Office of Management and Budget Circular A-25.<sup>311</sup> OMB Circular A-25 provides that agencies are to review user fees biennially and update them as necessary.

### **Federal Fee Amounts**

Beginning January 1, 2017, the federal fee is \$225 for a regular installment agreement; \$107 for a direct debit agreement; \$149 for an online payment agreement; \$31 for a direct debit online payment agreement; \$89 for restructured or reinstated installment agreements; and \$43 for low-income taxpayers to enter any type of agreement except direct debit online, for which the lower \$31 rate applies.<sup>312</sup>

### New Federal Law (IRC Section 6159)

The amount of any fee imposed on an installment agreement may not exceed the amount of the fee that is in effect as of the date of enactment, February 9, 2018.<sup>313</sup>

For taxpayers with an AGI, as determined for the most recent year for which such information is available, that does not exceed 250 percent of the applicable poverty level,<sup>314</sup> no fee is imposed if the taxpayer has agreed to make payments under the installment agreement by electronic payment through a debit instrument,<sup>315</sup> and if the taxpayer is unable to make payments under the installment agreement by electronic payment through a debit instrument, upon completion of the installment agreement, the IRS will reimburse the taxpayer an amount equal to the user fee imposed.<sup>316</sup>

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<sup>310</sup> Codified at 31 U.S.C. 9701.

<sup>311</sup> 58 FR 38142 (July 15, 1993) (OMB Circular A-25).

<sup>312</sup> Treasury Regulation section 300.1.

<sup>313</sup> IRC section 6159(f)(1).

<sup>314</sup> As determined by the IRS.

<sup>315</sup> IRC section 6159(f)(2)(A).

<sup>316</sup> IRC section 6159(f)(2)(B).

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Effective Date

This provision applies to installment agreements entered into on or after the date which is 60 days after the date of enactment, February 9, 2018.

California Law (R&TC Sections 19008 and 19590-19592)

California law allows taxpayers to enter into installment agreements and conforms to federal law by allowing all taxpayers to enter into installment agreements for less than the full amount of the tax due. In the case of an individual taxpayer, the law specifies that if the FTB determines that full payment can be made within 36 months, full payment would be required. The FTB is required to review an agreement for partial payment of tax liability at least once every two years.

The FTB is authorized<sup>317</sup> to charge a fee for providing specialized tax services including installment agreement programs. The current fees for entering into an installment agreement are \$34 for individuals and \$50 for business entities.

California does not conform to the federal changes to user fee requirements for installment agreements described above.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
41106	Form 1040SR for Seniors

Background

The IRS makes available three tax forms that individuals may use to file federal income taxes, which are Form 1040, Form 1040A, and Form 1040EZ. Form 1040EZ is the simplest of these tax forms, but generally may only be used by taxpayers that meet the following criteria:

- A filing status of single or married filing jointly.
- No dependents.
- No adjustments to income.
- No tax credits other than the earned income credit.
- Under age 65 and not blind (both if filing jointly) at the end of the taxable year.

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<sup>317</sup> R&TC sections 19591-19592.

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- Taxable income is less than \$100,000.
- Income only from wages, salaries, tips, taxable scholarship or fellowship grants, unemployment compensation, or Alaska Permanent Fund dividends, and taxable interest not over \$1,500.

New Federal Law (Uncodified Act Section 41106)

The provision directs the IRS to create a simplified income tax return form designated Form 1040SR, for use by persons age 65 or older for tax years beginning after the date of enactment, February 9, 2018. The form is to be as similar as possible to the Form 1040EZ, except the following limitations would apply:

- The form must be available only to individuals who have attained age 65 as of the close of the tax year,
- The form may be used even if income for the tax year includes:
  - Social security benefits (as defined in IRC section 86(d)),
  - Distributions from qualified retirement plans (as defined in IRC section 4974(c)),
  - Interest and dividends, or
  - Capital gains and losses used to determine adjusted net capital gain (as defined in IRC section 1(h)(3)), and
- The form must be available without regard to the amount of any item of taxable income or the total amount of taxable income for the tax year.

Effective Dates

The new federal form 1040SR shall be available effective for the taxable year beginning after the date of enactment, February 9, 2008.

California Law (R&TC sections 18621, and 19581-19583)

The FTB is authorized to create tax forms for the filing of income tax returns based on California tax law and filing requirements. California does not conform to the federal provisions that require the IRS to make available a new form 1040SR income tax return for individuals that are aged 65 or older.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
41107	Attorneys Fees Relating to Awards to Whistleblowers

Background

IRC section 7623 provides for a reward program for individuals who provide information regarding violations of the tax laws to the Secretary. Generally, the law establishes a reward floor of 15 percent of the collected proceeds (including penalties, interest, additions to tax and additional amounts) if the IRS moves forward with an administrative or judicial action based on information brought to the IRS's attention by an individual. The law caps the available reward at 30 percent of the collected proceeds. The law permits awards of lesser amounts (but no more than 10 percent) if the action was based principally on allegations (other than information provided by the individual) resulting from a judicial or administrative hearing, government report, hearing, audit, investigation, or from the news media.

The law provides that the Whistleblower Office may seek assistance from the individual providing information or from his or her legal representative, and may reimburse the costs incurred by any legal representative out of the amount of the reward. To the extent the disclosure of returns or return information is required to render such assistance, the disclosure must be pursuant to an IRS tax administration contract.

The law also provides an above-the-line deduction for attorneys' fees and costs paid by, or on behalf of, the individual in connection with any award for providing information regarding violations of the tax laws. The amount that may be deducted above-the-line may not exceed the amount includible in the taxpayer's gross income for the taxable year on account of such award (whether by suit or agreement and whether as lump sum or periodic payments).

The law permits an individual to appeal the amount or a denial of an award determination to the United States Tax Court (Tax Court) within 30 days of such determination. Under the law, Tax Court review of an award determination may be assigned to a special trial judge.

New Federal Law (IRC section 62(a)(21))

For taxable years beginning after December 31, 2017, the provision extends the above-the-line deduction for attorneys' fees and costs paid by, or on behalf of, the individual in connection with any award for providing information regarding violations of the tax laws to:<sup>318</sup>

- Any action brought under section 21F of the Securities Exchange Act of 1934,<sup>319</sup>
- A state law relating to false or fraudulent claims that meets the requirements described in section 1909(b) of the Social Security Act, or
- Section 23 of the Commodity Exchange Act.<sup>320</sup>

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<sup>318</sup> IRC section 62(a)(21)(A)(ii).

<sup>319</sup> 15 U.S.C. 22 78u-6.

<sup>320</sup> 7 U.S.C. 26.

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The amount that may be deducted above-the-line may not exceed the amount includible in the taxpayer's gross income for the taxable year on account of such award (whether by suit or agreement and whether as lump sum or periodic payments).

Effective Date

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

California Law (R&TC sections 17072 and 19525)

California conforms, under the PITL, to the definition of AGI under IRC section 62, as of the specified date of January 1, 2015,<sup>321</sup> with modifications, but does not conform to IRC section 62(a)(21) relating to awards to whistleblowers.<sup>322</sup> As a result, California does not conform to the federal change that expands the deduction for attorney's fee related to awards to whistleblowers.

California does not conform by reference to IRC section 7623 but instead has stand-alone law<sup>323</sup> that permits the FTB to establish a reward program for information resulting in the identification of underreported or unreported income subject to the PITL or the CTL. Any reward may not exceed 10 percent of the taxes collected as a result of the information provided. Any person employed by or under contract with any state or federal tax collection agency is not eligible for a reward under this section.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
41108	Clarification of Whistleblowers Awards

Background

IRC section 7623 provides for a reward program for individuals who provide information regarding violations of the tax laws to the Secretary. Generally, the law establishes a reward floor of 15 percent of the collected proceeds (including penalties, interest, additions to tax and additional amounts) if the IRS moves forward with an administrative or judicial action based on information brought to the IRS's attention by an individual. The law caps the available reward at 30 percent of the collected proceeds. The law permits awards of lesser amounts (but no more than 10 percent) if the action was based principally on allegations

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<sup>321</sup> R&TC section 17024.5.

<sup>322</sup> R&TC section 17072(c).

<sup>323</sup> R&TC section 19525.

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(other than information provided by the individual) resulting from a judicial or administrative hearing, government report, hearing, audit, investigation, or from the news media.

The law provides that the Whistleblower Office may seek assistance from the individual providing information or from his or her legal representative, and may reimburse the costs incurred by any legal representative out of the amount of the reward. To the extent the disclosure of returns or return information is required to render such assistance, the disclosure must be pursuant to an IRS tax administration contract.

The law also provides an above-the-line deduction for attorneys' fees and costs paid by, or on behalf of, the individual in connection with any award for providing information regarding violations of the tax laws. The amount that may be deducted above-the-line may not exceed the amount includible in the taxpayer's gross income for the taxable year on account of such award (whether by suit or agreement and whether as lump sum or periodic payments).

The law permits an individual to appeal the amount or a denial of an award determination to the Tax Court within 30 days of such determination. Under the law, Tax Court review of an award determination may be assigned to a special trial judge.

New Federal Law (IRC section 7623)

The provision clarifies that for purposes of whistleblower awards, the term "proceeds" includes:

- Penalties, interest, additions to tax, and additional amounts provided under the IRC, and
- Any proceeds arising from laws for which IRS is authorized to administer, enforce, or investigate, including criminal fines and civil forfeitures, and violations of reporting requirements.

Effective Date

The provision applies to information provided, at any time, with respect to which a final determination for an award has not been made before the date of enactment, February 9, 2018.

California Law (R&TC section 19525)

California does not conform by reference to IRC section 7623 but instead has stand-alone law<sup>324</sup> that permits the FTB to establish a reward program for information resulting in the identification of underreported or unreported income subject to the PITL or the CTL. Any reward may not exceed 10 percent of the taxes collected as a result of the information provided. Any person employed by or under contract with any state or federal tax collection agency is not eligible for a reward under this section.

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<sup>324</sup> R&TC section 19525.



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Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
41109	Clarification Regarding 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.<sup>325</sup> 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.<sup>326</sup> 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.<sup>327</sup> 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.<sup>328</sup> 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.<sup>329</sup>

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<sup>325</sup> The IRC does not expressly define the term “public charity,” but rather provides exceptions to those entities that are treated as private foundations.

<sup>326</sup> IRC section 509(a)(1) (referring to IRC sections 170(b)(1)(A)(i) through (iv) for a description of these organizations).

<sup>327</sup> Treasury Regulation section 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 section 1.170A-9(f)(3).

<sup>328</sup> 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).

<sup>329</sup> 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

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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.<sup>330</sup>

### **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)<sup>331</sup> 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)<sup>332</sup> 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.<sup>333</sup> 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

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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.

<sup>330</sup> 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 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.

<sup>331</sup> 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).

<sup>332</sup> IRC section 4942(g).

<sup>333</sup> IRC section 4940(e).

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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.<sup>334</sup>

### **Private Colleges and Universities**

Private colleges and universities generally are treated as public charities rather than private foundations<sup>335</sup> and thus are not subject to the private foundation excise tax on net investment income.

### **Excise Tax on Private Colleges and Universities**

The TCJA<sup>336</sup> imposed 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 educational institution as described in section 25A of the IRC;<sup>337</sup> (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<sup>338</sup>) 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

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<sup>334</sup> IRC section 4942(d)(2).

<sup>335</sup> IRC sections 509(a)(1) and 170(b)(1)(A)(ii).

<sup>336</sup> Public Law 115-97, Section 13701, enacted December 22, 2017.

<sup>337</sup> 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.

<sup>338</sup> 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.

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institution; or (3) is a supported organization<sup>339</sup> or a supporting organization<sup>340</sup> 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 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.

New Federal Law (IRC section 4968)

For purposes of the excise tax based on investment income of private colleges and universities, the provision clarifies the definition of an applicable educational institution, relating to student requirements, to include only “tuition-paying” students.

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.

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<u>Section</u>	<u>Section Title</u>
41110	Exception from Private Foundation Excess Business Holding Tax for Independently-Operated Philanthropic Business Holdings

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<sup>339</sup> IRC section 509(f)(3).

<sup>340</sup> IRC section 509(a)(3).

## Background

Private foundations are subject to tax on excess business holdings.<sup>341</sup> In general, a private foundation is permitted to hold 20 percent of the voting stock in a corporation, reduced by the amount of voting stock held by all disqualified persons (as defined in IRC section 4946). If it is established that no disqualified person has effective control of the corporation, a private foundation and disqualified persons together may own up to 35 percent of the voting stock of a corporation. A private foundation shall not be treated as having excess business holdings in any corporation if it owns (together with certain other related private foundations) not more than 2 percent of the voting stock and not more than 2 percent in value of all outstanding shares of all classes of stock in that corporation. Similar rules apply with respect to holdings in a partnership (“profits interest” is substituted for “voting stock” and “capital interest” for “nonvoting stock”) and to other unincorporated enterprises (by substituting “beneficial interest” for “voting stock”). Private foundations are not permitted to have holdings in a proprietorship. Foundations generally have a five-year period to dispose of excess business holdings (acquired other than by purchase) without being subject to tax. This five-year period may be extended an additional five years in limited circumstances. The excess business holdings rules do not apply to holdings in a functionally related business or to holdings in a trade or business at least 95 percent of the gross income of which is derived from passive sources.

The initial tax is equal to 10 percent of the value of the excess business holdings held during the foundation’s applicable taxable year. An additional tax is imposed if an initial tax is imposed and at the close of the applicable taxable period, the foundation continues to hold excess business holdings. The amount of the additional tax is equal to 200 percent of such holdings.

## New Federal Law (IRC section 4943)

The 10 percent excess business holding tax<sup>342</sup> does not apply to the business entity holdings of a private foundation which satisfies certain ownership, profits distribution, and independent operation requirements for the taxable year.<sup>343</sup>

### *Ownership Requirement*

For the exception to the tax on excess business holdings to apply, 100 percent of the voting stock in the business enterprise must be held by the private foundation at all times during the tax year, and all of the private foundation’s ownership interests in the business enterprise must have been acquired in ways other than by purchase.<sup>344</sup>

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<sup>341</sup> IRC section 4943. Taxes imposed may be abated if certain conditions are met. IRC sections 4961 and 4962.

<sup>342</sup> IRC section 4943(a).

<sup>343</sup> IRC section 4943(g)(1).

<sup>344</sup> IRC section 4943(g)(2).

### *Profits Distribution Requirement*

The business enterprise must distribute an amount equal to its net operating income for the taxable year to the private foundation, not later than 120 days after the close of the taxable year.<sup>345</sup>

For purposes of this exception, net operating income of any business enterprise for any taxable year is the gross income of the business enterprise for the taxable year, reduced by the sum of the deductions allowed by Chapter 1 of the IRC (relating to normal taxes and surcharges) for the taxable year which are directly connected with the production of the income, the tax imposed by Chapter 1 on the business enterprise for the taxable year, and an amount for a reasonable reserve for working capital and other business needs of the business enterprise.<sup>346</sup>

### *Independent Operation Requirement*

The requirements for independent operation are met if, at all times during the taxable year:

- No substantial contributor (as defined in IRC section 4958(c)(3)(C)) to the private foundation or family member (as determined under IRC section 4958(f)(4)) of such a contributor is a director, officer, trustee, manager, employee, or contractor of the business enterprise (or an individual having powers or responsibilities similar to any of those titles),
- At least a majority of the board of directors of the private foundation are persons who are not directors or officers of the business enterprise, or family members of a substantial contributor to the private foundation, and
- No loan is outstanding from the business enterprise to a substantial contributor to the private foundation, or to any family member of a substantial contributor.<sup>347</sup>

### *Certain Exceptions*

The exception from the excess business holdings tax for independently-operated philanthropic business holdings does not apply to:

- Any fund or organization treated as a private foundation under IRC section 4943(e), relating to donor advised funds being treated as private foundations, or IRC section 4943(f), relating to supporting organizations being treated as private foundations,
- Any charitable trust described in IRC section 4947(a)(1), and
- Any split-interest trust described in IRC section 4947(a)(2).<sup>348</sup>

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<sup>345</sup> IRC section 4943(g)(3)(A).

<sup>346</sup> IRC section 4943(g)(3)(B).

<sup>347</sup> IRC section 4943(g)(4).

<sup>348</sup> IRC section 4943(g)(5).

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Effective Dates

The provision is effective for taxable years beginning after December 31, 2017.

California Law (R&TC section 23732)

California does not conform by reference to IRC section 4943, relating to the excise tax on excess business holdings of private foundations, but instead imposes a tax on the “unrelated business income” of organizations exempt from tax.<sup>349</sup> As a result, the federal changes creating an exception to this excise tax are not applicable to California.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
41111	Rule of Construction for Craft Beverage Modernization and Tax Reform

Background

Subpart A of Part IX of Subtitle C of Title 1 of the TCJA (Subpart A)<sup>350</sup> modified the IRC related to craft beverages: excise taxes, interest capitalization rules, shared ownership requirements, and transfer of spirits requirements.

New Federal Law (Uncodified Act Section 41111 Adds Section 13809 to the TCJA)

The provision adds a new section 13809, Rule of Construction, to Subpart A which clarifies that any amendments made by, regulations promulgated under, or amendments to Subpart A shall not preempt, supersede, limit, or restrict any State, local, or tribal law that prohibits or regulates the production or sale of distilled spirits, wine, or malt beverages.

Effective Dates

The provision is effective as if included in the TCJA.

California Law (None)

The addition of the new federal section to the TCJA does not impact the PITL, the AFITL, or the CTL.

Impact on California Revenue

Not applicable.

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<sup>349</sup> R&TC section 23732.

<sup>350</sup> Public Law 115-97, enacted December 22, 2017.



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<u>Section</u>	<u>Section Title</u>
41112	Simplification of Rules Regarding Records, Statements, and Returns

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).

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.

Taxpayers subject to excise tax on beer are required to keep records, render statements, make returns, and comply with rules and regulations prescribed by the IRS.<sup>351</sup>

New Federal Law (IRC section 5555)

For calendar quarters beginning after the date of the enactment, February 9, 2018, and before January 1, 2020, the provision requires the IRS to permit taxpayers to employ a unified system for any records, statements, and returns required to be kept, rendered, or made for beer produced in a brewery for which an excise tax is imposed under IRC section 5051, including any beer which has been removed for consumption on the premises of the brewery.

Effective Dates

This provision applies to calendar quarters beginning after the date of enactment, February 9, 2018.

California Law (None )

The FTB does not administer these types of excise taxes.

Impact on California Revenue

The FTB does not administer these types of excise taxes.

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<sup>351</sup> IRC section 5555(a).

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<u>Section</u>	<u>Section Title</u>
41113	Modification of Rules Governing Hardship Distributions

Background

A qualified retirement plan<sup>352</sup> that is a profit-sharing plan may allow an employee to make an election between cash and an employer contribution to the plan pursuant to a qualified cash or deferred arrangement. A plan with this feature is generally referred to as an IRC section 401(k) plan.

An IRC section 401(k) plan may provide that elective deferrals are made for an employee at a specified rate unless the employee elects otherwise (i.e., elects not to make contributions or to make contributions at a different rate), provided that the employee has an effective opportunity to elect to receive cash in lieu of the default contributions. Such a plan design is sometimes referred to as “automatic enrollment.”

Besides elective deferrals, an IRC section 401(k) plan may provide for: (1) matching contributions, which are employer contributions that are made only if an employee makes elective deferrals; and (2) nonelective contributions, which are employer contributions that are made without regard to whether an employee makes elective deferrals. Under an IRC section 401(k) plan, no benefit other than matching contributions can be contingent on whether an employee makes elective deferrals. Thus, for example, an employee’s eligibility for benefits under a defined benefit pension plan cannot be contingent on whether the employee makes elective deferrals.

To be qualified, an IRC section 401(k) plan must also satisfy certain distribution limitation rules. Under these rules, elective contributions can’t be distributed until the occurrence of specific distributable events, one of which is financial hardship. A financial hardship distribution must be both made due to an immediate and heavy financial need, and necessary to satisfy the financial need.

A distribution is deemed necessary to satisfy an immediate and heavy financial need of an employee if all of the following requirements are satisfied if the employee:

- Has received all other currently available distributions, including distribution of ESOP dividends (excluding hardship distributions),
- Received any nontaxable loans under the plan and all other plans maintained by the employer,
- Is prohibited, under the terms of the plan or an otherwise legally enforceable agreement, from making elective contributions and employee contributions to the plan, and all other plans maintained by the employer, for at least six months after receipt of the financial hardship distribution. This includes a stock option plan, stock purchase plan, or similar plan maintained by the employer.

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<sup>352</sup> Qualified retirement plans include plans qualified under IRC section 401(a) and IRC section 403(a) annuity plans.

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Plans maintained by the employer are defined as all qualified and nonqualified deferred compensation plans maintained by the employer, including an IRC section 401(k) plan that is part of a cafeteria plan. However, the mandatory employee contribution portion of a defined benefit plan or a health or welfare benefit plan is not included, even if it is part of a cafeteria plan.

New Federal Law (Uncodified Act Section 41113 affecting IRC section 401(k))

The IRS must modify Treasury Regulation section 1.401(k)-1(d)(3)(iv)(E), no later than one year after the enactment date of February 9, 2018, to delete the six-month prohibition on contributions, and make any other modifications necessary to carry out the purposes of IRC section 401(k)(2)(B)(i)(IV).

Effective Dates

This revised regulations under this provision apply to plan years beginning after December 31, 2018.

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), 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 modification of rules governing hardship distributions 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.

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<u>Section</u>	<u>Section Title</u>
41114	Modification of Rules Relating to Hardship Withdrawals from Cash or Deferred Arrangements

Background

A qualified retirement plan<sup>353</sup> that is a profit-sharing plan may allow an employee to make an election between cash and an employer contribution to the plan pursuant to a qualified cash or deferred arrangement. A plan with this feature is generally referred to as an IRC section 401(k) plan.

An IRC section 401(k) plan may provide that elective deferrals are made for an employee at a specified rate unless the employee elects otherwise (i.e., elects not to make contributions or to make contributions at a different rate), provided that the employee has an effective opportunity to elect to receive cash in lieu of the default contributions. Such a plan design is sometimes referred to as “automatic enrollment.”

Besides elective deferrals, an IRC section 401(k) plan may provide for: (1) matching contributions, which are employer contributions that are made only if an employee makes elective deferrals; and (2) nonelective contributions, which are employer contributions that are made without regard to whether an employee makes elective deferrals. Under an IRC section 401(k) plan, no benefit other than matching contributions can be contingent on whether an employee makes elective deferrals. Thus, for example, an employee’s eligibility for benefits under a defined benefit pension plan cannot be contingent on whether the employee makes elective deferrals.

To be qualified, an IRC section 401(k) plan must also satisfy certain distribution limitation rules. Under these rules, elective contributions can’t be distributed until the occurrence of specific distributable events, one of which is financial hardship. A financial hardship distribution must be made due to an immediate and heavy financial need, and necessary to satisfy the financial need.

A distribution is deemed necessary to satisfy an immediate and heavy financial need of an employee if all of the following requirements are satisfied if the employee:

- Has received all other currently available distributions, including distribution of ESOP dividends (excluding hardship distributions),
- Received any nontaxable loans under the plan and all other plans maintained by the employer,
- Is prohibited, under the terms of the plan or an otherwise legally enforceable agreement, from making elective contributions and employee contributions to the plan, and all other plans maintained by the employer, for at least six months after receipt of the financial hardship distribution. This includes a stock option plan, stock purchase plan, or similar plan maintained by the employer.

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<sup>353</sup> Qualified retirement plans include plans qualified under IRC section 401(a) and IRC section 403(a) annuity plans.

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Plans maintained by the employer are defined as all qualified and nonqualified deferred compensation plans maintained by the employer, including an IRC section 401(k) plan that is part of a cafeteria plan. However, the mandatory employee contribution portion of a defined benefit plan or a health or welfare benefit plan is not included, even if it is part of a cafeteria plan.

New Federal Law (IRC section 401(k))

The provision allows the following amounts to be distributed upon financial hardship of the employee:

- Employer or employee contributions to a profit-sharing or stock bonus plan to which IRC section 402(e)(3) applies,
- Qualified nonelective contributions,
- Qualified matching contributions, and
- Earnings on any of the above.

Additionally, a distribution shall not fail to qualify under financial hardship solely because the employee does not take any available loan under the plan.

Effective Dates

This provision applies to plan years beginning after December 31, 2018.

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), 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 modification of rules relating to hardship withdrawals from cash or deferred arrangements automatically applies under California law without regard to taxable year to the same extent as applicable for federal income tax purposes.

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Impact on California Revenue

Baseline.

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<u>Section</u>	<u>Section Title</u>
41115	Opportunity Zone Rule for Puerto Rico

Background

Current law 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 law 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 law 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

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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



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indicators including job creation, poverty reduction and new business starts, and other metrics as determined by the Secretary.

New Federal Law (IRC section 1400Z-1)

The provision deems each population census tract in Puerto Rico that is a low-income community, as defined in IRC section 45D(e), to be certified and designated as an opportunity zone.

Effective Dates

This provision applies on the date of enactment of the TCJA, 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<sup>354</sup> is available for each taxable year beginning on or after January 1, 2014, and before January 1, 2026, 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.

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<u>Section</u>	<u>Section Title</u>
41116	Tax Home of Certain Citizens or Residents of the United States Living Abroad

Background

A U.S. citizen or resident living abroad may be eligible to elect to exclude from U.S. taxable income certain foreign earned income and foreign housing costs.<sup>355</sup> This exclusion applies regardless of whether any foreign tax is paid on the foreign earned income or housing costs. To qualify for these exclusions, an individual (a “qualified individual”) must have his or her

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<sup>354</sup> R&TC section 17053.73.

<sup>355</sup> IRC section 911.

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tax home in a foreign country and must be either (1) a U.S. citizen<sup>356</sup> who is a bona-fide resident of a foreign country or countries for an uninterrupted period that includes an entire taxable year, or (2) a U.S. citizen or resident present in a foreign country or countries for at least 330 full days in any 12-consecutive-month period.

The maximum amount of foreign earned income that an individual may exclude in 2018 is \$103,900.<sup>357</sup> The maximum amount of foreign housing costs that an individual may exclude in 2015 is, in the absence of Treasury adjustment for geographic differences in housing costs, \$16,128.<sup>358</sup> The combined foreign earned income exclusion and housing cost exclusion may not exceed the taxpayer's total foreign earned income for the taxable year. The taxpayer's foreign tax credit is reduced by the amount of the credit that is attributable to excluded income.

New Federal Law (IRC section 911)

Under the provision, individuals shall be treated as having a tax home in a foreign country for any period for which their abode is within the United States, while serving in an area designated by the President of the United States by Executive Order as a combat zone for purposes of section 112 in support of the Armed Forces of the United States.

Effective Dates

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

California Law (R&TC section)

California does not conform to IRC section 911, relating to United States citizens living abroad. Thus, the federal change to the definition of tax home for purposes of IRC section 911 are not applicable.

Impact on California Revenue

Not applicable.

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<sup>356</sup> Generally, only U.S. citizens may qualify under the bona-fide residence test. A U.S. resident alien who is a citizen of a country with which the United States has a tax treaty may, however, qualify for the IRC section 911 exclusions under the bona-fide residence test by application of a nondiscrimination provision of the treaty.

<sup>357</sup> IRC section 911(b)(2)(D)(i). This amount is adjusted annually for inflation. The exclusion amount is taken against the lowest marginal tax rates. See IRC section 911(f).

<sup>358</sup> IRC section 911(c)(1), (2). The Treasury Secretary has authority to issue guidance making geographic cost-based adjustments. See IRC section 911(c)(2)(B). The Secretary has exercised this authority annually. Notice 2015-33 (April 14, 2015), includes adjustments for many locations. Under these adjustments, the maximum housing cost exclusion for any geographic area is \$114,300 for expenses for housing in Hong Kong, China.

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<u>Section</u>	<u>Section Title</u>
41117	Treatment of Foreign Persons for Returns Relating to Payments Made in Settlement of Payment Card and Third Party Network Transactions

Background

Present law imposes a variety of information reporting requirements on participants in certain transactions. These requirements are intended to assist taxpayers in preparing their income tax returns and to help the 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.<sup>359</sup> 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.

IRC section 6050W requires any payment settlement entity making payment to a participating payee in settlement of reportable payment transactions to report annually to the IRS and to the participating payee the gross amount of such reportable payment transactions, as well as the name, address, and TIN of the participating payees. A "reportable payment transaction" means any payment card transaction and any third party network transaction.

Under this section, a "payment settlement entity" means, in the case of a payment card transaction, a merchant acquiring entity and, in the case of a third party network transaction, a third party settlement organization. A "participating payee" means, in the case of a payment card transaction, any person who accepts a payment card as payment and, in the case of a third party network transaction, any person who accepts payment from a third party settlement organization in settlement of such transaction. Except as provided in regulations issued by the Secretary or other guidance, a participating payee does not include any person with a foreign address.

For purposes of the reporting requirement, the term "merchant acquiring entity" means the bank or other organization with the contractual obligation to make payment to participating payees in settlement of payment card transactions. A "payment card transaction" means any transaction in which a payment card is accepted as payment.<sup>360</sup> A "payment card" is defined as any card (e.g., a credit card or debit card) which is issued pursuant to an agreement or arrangement which provides for: (1) one or more issuers of such cards;

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<sup>359</sup> IRC section 6041(a).

<sup>360</sup> For this purpose, the acceptance as payment of any account number or other indicia associated with a payment card also qualifies a payment card transaction.

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(2) a network of persons unrelated to each other, and to the issuer, who agree to accept such cards as payment; and (3) standards and mechanisms for settling the transactions between the merchant acquiring entities and the persons who agree to accept such cards as payment. Thus, under the section, a bank that enrolls a business to accept credit cards and contracts with the business to make payment on credit card transactions is required to report to the IRS the business's gross credit card transactions for each calendar year. The bank also is required to provide a copy of the information report to the business.

The section also requires reporting on a third party network transaction. The term "third party network transaction" means any transaction which is settled through a third party payment network. A "third party payment network" is defined as any agreement or arrangement that: (1) involves the establishment of accounts with a central organization by a substantial number of persons (e.g., more than 50) who are unrelated to such organization, provide goods or services, and have agreed to settle transactions for the provision of such goods or services pursuant to such agreement or arrangement; (2) provides for standards and mechanisms for settling such transactions; and (3) guarantees persons providing goods or services pursuant to such agreement or arrangement that such persons will be paid for providing such goods or services. In the case of a third party network transaction, the payment settlement entity is the third party settlement organization, which is defined as the central organization which has the contractual obligation to make payment to participating payees of third party network transactions. Thus, an organization generally is required to report if it provides a network enabling buyers to transfer funds to sellers who have established accounts with the organization and have a contractual obligation to accept payment through the network. However, an organization operating a network which merely processes electronic payments (such as wire transfers, electronic checks, and direct deposit payments) between buyers and sellers, but does not have contractual agreements with sellers to use such network, is not required to report under the provision. Similarly, an agreement to transfer funds between two demand deposit accounts will not, by itself, constitute a third party network transaction.

A third party payment network does not include any agreement or arrangement that provides for the issuance of payment cards as defined by the provision. In addition, a third party settlement organization is not required to report unless the aggregate value of third party network transactions for the year exceeds \$20,000 and the aggregate number of such transactions exceeds 200. For the avoidance of doubt, if a payment of funds is made to a third party settlement organization by means of a payment card (i.e., as part of a transaction that is a payment card transaction), the \$20,000 and 200 transaction *de minimis* rule continues to apply to any reporting obligation with respect to payment of such funds to a participating payee by the third party settlement organization made as part of a third party network transaction.

The section also imposes reporting requirements on intermediaries who receive payments from a payment settlement entity and distribute such payments to one or more participating payees. The provision treats such intermediaries as participating payees with respect to the payment settlement entity and as payment settlement entities with respect to the participating payees to whom the intermediary distributes payments. Thus, for example, in the case of a corporation that receives payment from a bank for credit card sales

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effectuated at the corporation's independently-owned franchise stores, the bank is required to report the gross amount of reportable payment transactions settled through the corporation (notwithstanding the fact that the corporation does not accept payment cards and would not otherwise be treated as a participating payee). In turn, the corporation, as an intermediary, would be required to report the gross amount of reportable payment transactions allocable to each franchise store. The bank would have no reporting obligation with respect to payments made by the corporation to its franchise stores.

If a payment settlement entity contracts with a third party to settle reportable payment transactions on behalf of the payment settlement entity, the section requires the third party to file the annual information return in lieu of the payment settlement entity.

The section grants authority to the Secretary to issue guidance to implement the reporting requirement, including rules to prevent the reporting of the same transaction more than once.

Also, reportable payment transactions subject to information reporting generally are subject to backup withholding requirements. Finally, penalties relating to the failure to file correct information returns apply to the information reporting requirements required under the section.

New Federal Law (IRC section 6050W)

Under the provision, a person with a foreign address shall not be treated as a participating payee with respect to any payment settlement entity solely because such person receives payments from a payment settlement entity in dollars.

Effective Dates

This provision applies to returns for calendar years beginning after December 31, 2017.

California Law (R&TC section 18631)

California does not conform by reference to IRC sections requiring information returns to be filed, but instead provides, under the AFITL,<sup>361</sup> that the FTB may require a copy of any information return required to be filed with the Secretary under IRC section 6050W, relating to treatment of foreign persons for returns relating to payments made in settlement of payment card and third party network 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.

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<sup>361</sup> R&TC section 18631(c)(25).

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<u>Section</u>	<u>Section Title</u>
41118	Repeal of Shift in Time of Payment of Corporate Estimated Taxes

Background

In general, corporations are required to make quarterly estimated tax payments of their income tax liability.<sup>362</sup> For a corporation whose taxable year is a calendar year, these estimated tax payments must be made by April 15, June 15, September 15, and December 15. The amount of any required estimated payment is 25 percent of the required annual payment.<sup>363</sup> The required annual payment is 100 percent of the tax liability for the taxable year or the preceding taxable year. The option to use the preceding taxable year is not available if the preceding taxable year was not a 12-month taxable year or the corporation did not file a return in the preceding taxable year showing a liability for tax. Further, in the case of a corporation with taxable income of at least \$1 million in any of the three immediately preceding taxable years, the option to use the preceding taxable year is only available for the first installment of such corporation's taxable year.<sup>364</sup> In addition, in the case of a corporation with assets of at least \$1 billion (determined as of the end of the preceding taxable year), payments due in July, August or September of 2017, are increased to 100.25 percent of the payment otherwise due. For each of the periods affected, the next required payment is reduced accordingly (i.e., payments due in October, November, or December of 2017, are reduced by the amount that the prior payment was increased).

In the case of a corporation with assets of at least \$1 billion (determined as of the end of the preceding taxable year), the amount of the required installment of estimated tax otherwise due in July, August, or September of 2020, is increased by 8 percent of that amount (determined without regard to any increase in such amount not contained in the IRC) (i.e., the installment due in July, August or September of 2020, is increased to 108 percent of the payment otherwise due). The next required installment is reduced accordingly (i.e., the payment due in October, November, or December of 2020, is reduced by the amount that the prior payment was increased).

New Federal Law (Uncodified Section 41118 affecting Section 803 of the Trade Preferences Extension Act of 2015 (TPEA)<sup>365</sup> and IRC section 6655)

Repeals the shift in time of payment of corporate estimated taxes in the case of a corporation with assets of at least \$1 billion.

Effective Date

The provision applies as of the date of enactment of the TPEA, June 29, 2015.

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<sup>362</sup> IRC section 6655.

<sup>363</sup> IRC section 6651(d)(1).

<sup>364</sup> IRC section 6655(d)(2) and (g)(2).

<sup>365</sup> Public Law 114-27, enacted June 29, 2015.

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California Law (R&TC section 19025)

California does not conform to IRC section 6655, but instead has its own stand-alone rules for time for payment of corporation estimated tax payments.

In general, corporation estimated tax payments of tax liability are due in quarterly increments, beginning 3 months and 15 days after the beginning of the taxable year, and the percentages of the quarterly increments due are generally 30 percent for the first quarter, 40 percent for the second quarter, zero percent for the third quarter, and 30 percent for the fourth quarter.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
41119	Enhancement of Carbon Dioxide Sequestration Credit

Background

A credit of \$20 per metric ton is available for qualified carbon dioxide captured by a taxpayer at a qualified facility and disposed of by such taxpayer in secure geological storage (including storage at deep saline formations and unminable coal seams under such conditions as the Secretary may determine).<sup>366</sup> In addition, a credit of \$10 per metric ton is available for qualified carbon dioxide that is captured by the taxpayer and sequestered in permanent geological storage at a qualified facility and used by such taxpayer as a tertiary injectant (including carbon dioxide augmented water-flooding and immiscible carbon dioxide displacement) in a qualified enhanced oil or natural gas recovery project. The term permanent geological storage includes oil and gas reservoirs in addition to unminable coal seams and deep saline formations. In addition, the Secretary must consult with the Administrator of the Environmental Protection Agency, the Secretary of Energy, and the Secretary of the Interior, in promulgating regulations relating to the permanent geological storage of carbon dioxide. Both credit amounts are adjusted for inflation after 2009.

Qualified carbon dioxide is defined as carbon dioxide captured from an industrial source that (1) would otherwise be released into the atmosphere as an industrial emission of greenhouse gas, and (2) is measured at the source of capture and verified at the point or points of injection. Qualified carbon dioxide includes the initial deposit of captured carbon dioxide used as a tertiary injectant but does not include carbon dioxide that is recaptured, recycled, and re-injected as part of an enhanced oil or natural gas recovery project process. A qualified enhanced oil or natural gas recovery project is a project that would otherwise

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<sup>366</sup> IRC section 45Q.



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meet the definition of an enhanced oil recovery project under IRC section 43, if natural gas projects were included within that definition.

A qualified facility means any industrial facility (1) which is owned by the taxpayer, (2) at which carbon capture equipment is placed in service, and (3) which captures not less than 500,000 metric tons of carbon dioxide during the taxable year. The credit applies only with respect to qualified carbon dioxide captured and sequestered or injected in the United States<sup>367</sup> or one of its possessions.<sup>368</sup>

Except as provided in regulations, credits are attributable to the person that captures and physically or contractually ensures the disposal, or use as a tertiary injectant, of the qualified carbon dioxide. Credits are subject to recapture, as provided by regulation, with respect to any qualified carbon dioxide that ceases to be recaptured, disposed of, or used as a tertiary injectant in a manner consistent with the rules of the provision.

The credit is part of the general business credit. The credit sunsets at the end of the calendar year in which the Secretary, in consultation with the Administrator of the Environmental Protection Agency, certifies that 75 million metric tons of qualified carbon dioxide have been captured and disposed of or used as a tertiary injectant.

New Federal Law (IRC section 45Q)

Under the provision, the carbon dioxide sequestration credit was renamed as the carbon oxide sequestration credit and modified for any tax year to be an amount equal to the sum of:

1. \$20 per metric ton of qualified carbon oxide which is captured by the taxpayer using carbon capture equipment which is originally placed in service at a qualified facility before Feb. 9, 2018, and disposed of by the taxpayer in secure geological storage and not used by the taxpayer as described in 2 below,<sup>369</sup>
2. \$10 per metric ton of qualified carbon oxide which is captured by the taxpayer using carbon capture equipment which is originally placed in service at a qualified facility before Feb. 9, 2018, and used by the taxpayer as a tertiary injectant in a qualified enhanced oil or natural gas recovery project (EOR project) and disposed of by the taxpayer in secure geological storage, or utilized by the taxpayer in a matter described in IRC section 45Q(f)(5), relating to various alternate carbon oxide utilizations,
3. The applicable dollar amount per metric ton of qualified carbon oxide which is captured by the taxpayer using carbon capture equipment which is originally placed in service at a qualified facility after Feb. 8, 2018, during the 12-year period beginning on the date the equipment was originally placed in service, and disposed

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<sup>367</sup> IRC section 638(1).

<sup>368</sup> IRC section 638(2).

<sup>369</sup> IRC section 45Q(a)(2)(B).

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of by the taxpayer in secure geological storage and not used by the taxpayer as described in 2 above,<sup>370</sup> and

4. The applicable dollar amount per metric ton of qualified carbon oxide which is captured by the taxpayer using carbon capture equipment which is originally placed in service at a qualified facility after Feb. 8, 2018, during the 12-year period beginning on the date the equipment was originally placed in service, and used by the taxpayer as a tertiary injectant in a qualified EOR project and disposed of by the taxpayer in secure geological storage, or utilized by the taxpayer in a manner described in IRC section 45Q(f)(5), relating to alternate carbon oxide utilizations.

The provision allows a taxpayer to elect to have the dollar amounts applicable under 1 or 2 above apply instead of the dollar amounts applicable under 3 or 4 above for each metric ton of qualified carbon oxide which is captured by the taxpayer using carbon capture equipment which is originally placed in service at a qualified facility after February 8, 2018.

The IRS will issue regulations providing for the recapture of the benefit of any carbon oxide sequestration credit for any qualified carbon oxide which ceases to be captured, disposed of, or used as a tertiary injectant in a consistent manner.

For purposes of the carbon oxide sequestration credit, the provision defines a qualified facility as any industrial facility or direct air capture facility the construction of which begins before January 1, 2024, and construction of carbon capture equipment begins before January 1, 2024, or the original planning and design for the facility includes installation of carbon capture equipment. Additionally, a qualified facility must capture, in the case of a facility which emits not more than 500,000 metric tons of carbon oxide into the atmosphere during the tax year, not less than 25,000 metric tons of qualified carbon oxide during the tax year which is utilized in a manner described in IRC section 45A(f)(5), relating to alternate carbon oxide utilizations. In the case of an electricity generating facility which is not described in IRC section 45Q(d)(2)(A), relating to emissions of alternate carbon oxide utilizations, less than 500,000 metric tons of qualified carbon oxide during the tax year. In the case of a direct air capture facility or any facility not described in IRC section 45Q(d)(2)(A) or 45Q(d)(2)(B), relating to emissions of alternate carbon oxide utilizations, not less than 100,000 metric tons of qualified carbon oxide during the tax year.

Effective Date

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

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<sup>370</sup> IRC section 45Q(a)(4)(B).

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California Law (None)

California has no comparable credit.

Impact on California Revenue

Not applicable.

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**Division T—Revenue Provisions**

<u>Section</u>	<u>Section Title</u>
101	Modification of Deduction for Qualified Business Income of a Cooperative and its Patrons

Background

**Prior Law Treatment of Taxpayers with Domestic Production Activities Income**

*In General*

The former IRC section 199<sup>371</sup> deduction was determined by only taking into account items that were attributable to the actual conduct of a trade or business.<sup>372</sup> IRC section 199 provided a deduction from taxable income (or, in the case of an individual, AGI<sup>373</sup>) that was 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.<sup>374</sup> The amount of the deduction for a taxable year was 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 ended in such taxable year.<sup>375</sup> W-2 wages were the total wages subject to wage withholding,<sup>376</sup> elective deferrals,<sup>377</sup> and deferred compensation<sup>378</sup> paid by the taxpayer with respect to employment of its employees during the calendar year ending during the taxable year of the taxpayer.<sup>379</sup>

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<sup>371</sup> Former IRC section 199 was repealed by Public Law 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, commonly referred to as The Tax Cuts and Jobs Act, for taxable years beginning after December 31, 2017. All references to IRC section 199 in this section, discussing the prior law treatment, refer to IRC section 199 as in effect before its repeal.

<sup>372</sup> IRC section 199(d)(5).

<sup>373</sup> For this purpose, AGI was determined after application of IRC sections 86, 135, 137, 219, 221, 222, and 469, and without regard to the IRC section 199 deduction. IRC section 199(d)(2).

<sup>374</sup> IRC section 199(a).

<sup>375</sup> IRC section 199(b).

<sup>376</sup> Defined in IRC section 3401(a).

<sup>377</sup> Within the meaning of IRC section 402(g)(3).

<sup>378</sup> Deferred compensation included compensation deferred under IRC section 457, as well as the amount of any designated Roth contributions (as defined in IRC section 402A).

<sup>379</sup> IRC section 199(b). In the case of a taxpayer with a short taxable year that did not contain a calendar year ending during such short taxable year, the following amounts were treated as the W-2 wages of the taxpayer for the short taxable year: (1) wages paid during the short taxable year to employees of the qualified trade or business; (2) elective deferrals (within the meaning of IRC section 402(g)(3)) made during the short taxable year by employees of the qualified trade or business; and (3) compensation actually deferred under IRC section 457 during the short taxable year with respect to employees of the qualified trade or business. Amounts that were treated as W-2 wages for a taxable year were not treated as W-2 wages of any other taxable year. See Treas. Reg. section 1.199-2(b). In addition, in the case of a taxpayer who was an individual with otherwise qualified production activities income from sources within the commonwealth of Puerto Rico, if all the income for the taxable year was taxable under IRC section 1 (income tax rates for individuals), the determination of W-2 wages with respect to the taxpayer's trade or business conducted in Puerto Rico was made without regard to any exclusion under the wage withholding rules (as provided in IRC section 3401(a)(8)) for remuneration paid for services in Puerto Rico. See IRC section 199(d)(8)(B).

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W-2 wages did not include any amount that was not properly allocable to domestic production gross receipts as a qualified item of deduction.<sup>380</sup> In addition, W-2 wages did not include any amount that was not properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for such return.<sup>381</sup>

In the case of oil related qualified production activities income, the deduction was reduced by three percent of the least of the taxpayer's oil related qualified production activities income, qualified production activities income, or taxable income (determined without regard to the IRC section 199 deduction) for the taxable year.<sup>382</sup> For this purpose, oil related qualified production activities income for any taxable year was the portion of qualified production activities income attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof<sup>383</sup> during the taxable year.

In general, qualified production activities income was equal to domestic production gross receipts reduced by the sum of: (1) the cost of goods sold that were allocable to those receipts;<sup>384</sup> and (2) other expenses, losses, or deductions properly allocable to those receipts.<sup>385</sup> domestic production gross receipts generally were a taxpayer's gross receipts derived from: (1) any sale, exchange, or other disposition, or any lease, rental, or license, of qualifying production property<sup>386</sup> that were manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the U.S.;<sup>387</sup> (2) any sale, exchange, or other disposition, or any lease, rental, or license, of any qualified film<sup>388</sup> 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 U.S.; (4) construction of real property performed in the U.S. by a taxpayer in the ordinary course of a construction trade or business; or (5) engineering or

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<sup>380</sup> IRC section 199(b)(2)(B).

<sup>381</sup> IRC section 199(b)(2)(C).

<sup>382</sup> IRC section 199(d)(9).

<sup>383</sup> Within the meaning of IRC section 927(a)(2)(C) as in effect before its repeal.

<sup>384</sup> For this purpose, any item or service brought into the U.S. was treated as acquired by purchase, and its cost is treated as not less than its value immediately after it entered the U.S. A similar rule applied in determining the adjusted basis of leased or rented property where the lease or rental gave rise to domestic production gross receipts. In addition, for any property exported by the taxpayer for further manufacture, the increase in cost or adjusted basis could not exceed the difference between the value of the property when exported and the value of the property when brought back into the U.S. after the further manufacture. See IRC section 199(c)(3)(A) and (B).

<sup>385</sup> IRC section 199(c)(1). In computing qualified production activities income, the domestic production activities deduction itself was not an allocable deduction. IRC section 199(c)(1)(B)(ii). See Treas. Reg. sections 1.199-1 through 1.199-9 where the Secretary prescribed rules for the proper allocation of items of income, deduction, expense, and loss for purposes of determining qualified production activities income.

<sup>386</sup> Qualifying production property generally included any tangible personal property, computer software, and sound recordings. IRC section 199(c)(5).

<sup>387</sup> When used in the IRC 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, 2018, 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 were taxable under the federal income tax for individuals or corporations for such taxable year. IRC section 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).

<sup>388</sup> Qualified film included 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) constituted compensation for services performed in the U.S. by actors, production personnel, directors, and producers. IRC section 199(c)(6).

architectural services performed in the U.S. by the taxpayer for the construction of real property in the U.S.<sup>389</sup>

Domestic production gross receipts did not include any gross receipts of the taxpayer derived from property leased, licensed, or rented by the taxpayer for use by any related person.<sup>390</sup> In addition, domestic production gross receipts did not include gross receipts which were derived from (1) the sale of food and beverages prepared by the taxpayer at a retail establishment, (2) the transmission or distribution of electricity, natural gas, or potable water, or (3) the lease, rental, license, sale, exchange, or other disposition of land.<sup>391</sup>

### *Special Rules*

All members of an expanded affiliated group<sup>392</sup> were treated as a single corporation and the deduction was allocated among the members of the expanded affiliated group in proportion to each member's respective amount, if any, of qualified production activities income. In addition, for purposes of determining domestic production gross receipts, if all of the interests in the capital and profits of a partnership were owned by members of a single expanded affiliated group at all times during the taxable year of such partnership, the partnership and all members of such group were treated as a single taxpayer during such period.<sup>393</sup>

For a tax-exempt taxpayer subject to tax on its unrelated business taxable income by IRC section 511, the IRC section 199 deduction was determined by substituting unrelated business taxable income for taxable income where applicable.<sup>394</sup>

### *Partnerships and S Corporations*

With regard to the domestic production activities income of a partnership or S corporation, the deduction was determined at the partner or shareholder level. Each partner or shareholder would generally take into account such person's allocable share of the components of the calculation (including domestic production gross receipts; the cost of goods sold allocable to such receipts; and other expenses, losses, or deductions allocable to such receipts) from the partnership or S corporation, as well as any items relating to the partner's or shareholder's own qualified production activities income, if any.<sup>395</sup>

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<sup>389</sup> IRC section 199(c)(4)(A).

<sup>390</sup> IRC section 199(c)(7). For this purpose, a person was treated as related to another person if such persons were treated as a single employer under subsection (a) or (b) of IRC section 52 or subsection (m) or (o) of IRC section 414, except that determinations under subsections (a) and (b) of IRC section 52 were made without regard to IRC section 1563(b).

<sup>391</sup> IRC section 199(c)(4)(B).

<sup>392</sup> For this purpose, an expanded affiliated group was an affiliated group as defined in IRC section 1504(a) determined (i) by substituting "more than 50 percent" for "more than 80 percent" each place it appeared, and (ii) without regard to paragraphs (2) and (4) of IRC section 1504(b). See IRC section 199(d)(4)(B).

<sup>393</sup> IRC section 199(d)(4)(D).

<sup>394</sup> IRC section 199(d)(7).

<sup>395</sup> IRC section 199(d)(1)(A).

In applying the wage limitation, each partner or shareholder was treated as having been allocated wages from the partnership or S corporation in an amount equal to such person's allocable share of W-2 wages.<sup>396</sup>

### *Specified Agricultural and Horticultural Cooperatives*

#### *Definition of a Specified Agricultural or Horticultural Cooperative*

A specified agricultural or horticultural cooperative is an organization to which part I of subchapter T applied that was engaged in (a) the manufacturing, production, growth, or extraction in whole or significant part of any agricultural or horticultural product, or (b) the marketing of agricultural or horticultural products that its patrons have so manufactured, produced, grown, or extracted.<sup>397</sup>

#### *In General*

With regard to specified agricultural and horticultural cooperatives, IRC section 199 provided the same treatment of qualified production activities income derived from agricultural or horticultural products that are manufactured, produced, grown, or extracted by such cooperatives,<sup>398</sup> as it provided for qualified production activities income of other taxpayers, including non-specified cooperatives (*i.e.*, the cooperative could claim a deduction for qualified production activities income). The cooperative was treated as having manufactured, produced, grown, or extracted in whole or significant part any qualifying production property marketed by the cooperative if such items were manufactured, produced, grown, or extracted in whole or significant part by its patrons.<sup>399</sup> In addition, the cooperative was treated as having manufactured, produced, grown, or extracted agricultural products with respect to which the cooperative performs storage, handling, or other processing activities (other than transportation activities) within the U.S. related to the sale, exchange, or other disposition of agricultural products, provided the products are consumed in connection with or incorporated into the manufacturing, production, growth, or extraction of qualifying production property (whether or not by the cooperative).<sup>400</sup> Finally, for purposes of determining the cooperative's IRC section 199 deduction, qualified production activities income and taxable income were determined without regard to any deduction allowable under IRC section 1382(b) and (c) (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions) for the taxable year.<sup>401</sup>

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<sup>396</sup> In the case of a trust or estate, the components of the calculation were apportioned between (and among) the beneficiaries and the fiduciary. See IRC section 199(d)(1)(B) and Treas. Reg. section 1.199-5(d) and (e).

<sup>397</sup> IRC section 199(d)(3)(F). For this purpose, agricultural or horticultural products also included fertilizer, diesel fuel and other supplies used in agricultural or horticultural production that were manufactured, produced, grown, or extracted by the cooperative. See Treas. Reg. section 1.199-6(f).

<sup>398</sup> For this purpose, agricultural or horticultural products also included fertilizer, diesel fuel, and other supplies used in agricultural or horticultural production that are manufactured, produced, grown, or extracted by the cooperative. See Treas. Reg. section 1.199-6(f).

<sup>399</sup> IRC section 199(d)(3)(D) and Treas. Reg. section 1.199-6(d).

<sup>400</sup> See Treas. Reg. section 1.199-3(e)(1).

<sup>401</sup> See IRC section 199(d)(3)(C) and Treas. Reg. section 1.199-6(c).



### *Allocation of the Cooperative's Deduction to Patrons*

Any patron that received a qualified payment from a specified agricultural or horticultural cooperative was allowed as a deduction for the taxable year in which such payment was received an amount equal to the portion of the cooperative's deduction for qualified production activities income that was (i) allowed with respect to the portion of the qualified production activities income to which such payment was attributable, and (ii) identified by the cooperative in a written notice mailed to the patron during the payment period described in IRC section 1382(d).<sup>402</sup> A qualified payment was any amount that (i) was described in paragraph (1) or (3) of IRC section 1385(a) (*i.e.*, patronage dividends and per-unit retain allocations), (ii) was received by an eligible patron from a specified agricultural or horticultural cooperative, and (iii) was attributable to qualified production activities income with respect to which a deduction was allowed to such cooperative.<sup>403</sup>

The cooperative could not reduce its income under IRC section 1382 for any deduction allowable to its patrons under this rule (*i.e.*, the cooperative was required to reduce its allowed deductions for certain payments to its patrons in an amount equal to the IRC section 199 deduction allocated to its patrons).<sup>404</sup>

## **Present Law Treatment of Taxpayers Other than Corporations in General**

### *In General*

#### *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 status (*i.e.*, single, head of household, married filing jointly, or married filing separately). For 2018, the regular individual income tax rate schedule provides rates of 10, 12, 22, 24, 32, 35, and 37 percent.

#### *Partnerships*

Partnerships generally are treated for federal income tax purposes as pass-through entities not subject to tax at the entity level.<sup>405</sup> 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

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<sup>402</sup> IRC section 199(d)(3)(A) and Treas. Reg. section 1.199-6(a). The written notice was required to be mailed by the cooperative to its patrons no later than the 15<sup>th</sup> day of the ninth month following the close of the taxable year. The cooperative was required to report the amount of the patron's IRC section 199 deduction on Form 1099-PATR, "Taxable Distributions Received From Cooperatives," issued to the patron. Treas. Reg. section 1.199-6(g).

<sup>403</sup> IRC section 199(d)(3)(E). For this purpose, patronage dividends and per-unit retain allocations included any advances on patronage and per-unit retains paid in money during the taxable year. Treas. Reg. section 1.199-6(e).

<sup>404</sup> IRC section 199(d)(3)(B) and Treas. Reg. section 1.199-6(b).

<sup>405</sup> IRC section 701.

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the income is distributed to the partners).<sup>406</sup> A partner's deduction for partnership losses is limited to the partner's adjusted basis in its partnership interest.<sup>407</sup> Losses in excess 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.<sup>408</sup> Partners generally may receive distributions of partnership property without triggering taxable gain or loss, with some exceptions.<sup>409</sup>

Partnerships may allocate items of income, gain, loss, deduction, and credit among the partners, provided the allocations have substantial economic effect.<sup>410</sup> 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.<sup>411</sup>

Limited liability companies<sup>412</sup> (LLCs) are a recognized entity in every state and are neither partnerships nor corporations under applicable state law. However, under the “check-the-box” rules for federal tax purposes, an LLC is generally treated as a partnership (an LLC with multiple members) or as a disregarded entity (an LLC with a single member).<sup>413</sup>

A publicly traded partnership generally is treated as a corporation for federal tax purposes.<sup>414</sup> 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).<sup>415</sup>

An exception from corporate treatment is provided for certain publicly traded partnerships, 90 percent or more of whose gross income is qualifying income.<sup>416</sup>

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<sup>406</sup> IRC section 702(a).

<sup>407</sup> 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 (IRC 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.

<sup>408</sup> IRC section 705.

<sup>409</sup> 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).

<sup>410</sup> IRC section 704(b)(2).

<sup>411</sup> Treas. Reg. section 1.704-1(b)(2).

<sup>412</sup> 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.

<sup>413</sup> Any domestic non-publicly 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 a corporation for federal income tax purposes. Treas. Reg. section 301.7701-3 (known as the “check-the-box” regulations).

<sup>414</sup> IRC section 7704(a).

<sup>415</sup> IRC section 7704(b).

<sup>416</sup> 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

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### *S corporations*

For federal income tax purposes, an S corporation<sup>417</sup> generally is not subject to tax at the corporate level.<sup>418</sup> 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 in excess 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.<sup>419</sup>

In general, an 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.

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.<sup>420</sup> Only individuals (other than nonresident aliens), certain tax-exempt organizations, and certain trusts and estates may be 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.<sup>421</sup> Rather, the business owner is taxed directly on business income, and files Schedule

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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. Qualifying income 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 IRC section 851(a) if it were a domestic corporation), which includes a corporation registered under the Investment Company Act of 1940 (Pub. L. No. 76, 768 (1940)) as a management company or unit investment trust. IRC section 7704(c)(3).

<sup>417</sup> An S corporation is so named because its federal tax treatment is governed by subchapter S of the IRC.

<sup>418</sup> IRC sections 1363 and 1366.

<sup>419</sup> 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, such increase is instead first applied to restore the reduction in the basis of the shareholder's indebtedness. IRC section 1367(b)(2).

<sup>420</sup> IRC section 1361. For this purpose, a husband and wife and all members of a family are treated as one shareholder. IRC section 1361(c)(1).

<sup>421</sup> A single-member unincorporated entity is disregarded for federal income tax purposes, unless its owner elects to be treated as a C corporation. Treas. Reg. section 301.7701-3(b)(1)(ii). Sole proprietorships often are conducted

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,<sup>422</sup> for certain excise taxes,<sup>423</sup> and certain information reporting requirements.<sup>424</sup>

### *Taxpayers Other than Corporations with Qualified Business Income*

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 real estate investment trust (REIT) dividends, qualified cooperative dividends, and qualified publicly traded partnership income.<sup>425</sup> Limitations based on W-2 wages and capital investment phase in above a threshold amount of taxable income.<sup>426</sup> A disallowance of the deduction on income of specified service trades or businesses also phases in above the threshold amount of taxable income.

### *Qualified Business Income*

#### *In General*

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 such items only to the extent included or allowed in the determination of taxable income for the year. 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 U.S.<sup>427</sup> In the case of an individual with qualified business income from sources within the commonwealth of Puerto Rico, if all such income for the taxable year is taxable under IRC section 1 (income tax rates for individuals), then the term “United States” is considered to include Puerto Rico for purposes of determining the individual's qualified business income.<sup>428</sup>

Qualified items of income, gain, deduction, or loss,<sup>429</sup> specifically exclude (1) any item taken into account in determining net capital gain or net capital loss, (2) dividends, income equivalent to a dividend, or payments in lieu of dividends, (3) interest income other than that which is properly

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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).

<sup>422</sup> Treas. Reg. section 301.7701-2(c)(2)(iv).

<sup>423</sup> Treas. Reg. section 301.7701-2(c)(2)(v).

<sup>424</sup> Treas. Reg. section 301.7701-2(c)(2)(vi).

<sup>425</sup> IRC section 199A. Eligible taxpayers also include fiduciaries and beneficiaries of trusts and estates with qualified business income.

<sup>426</sup> For this purpose, taxable income is computed without regard to the 20-percent deduction.

IRC section 199A(e)(1).

<sup>427</sup> 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 for “a foreign corporation,” each place they appear. IRC section 199A(c)(3)(A).

<sup>428</sup> IRC section 199A(f)(1)(C).

<sup>429</sup> See IRC section 199A(c)(3)(B).

allocable to a trade or business, (4) the excess of gain over loss from commodities transactions other than (i) those entered into in the normal course of the trade or business or (ii) 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 received in connection with the trade or business.

If the net amount of qualified business income from all qualified trades or businesses during the taxable year is a loss, then such loss is carried forward and in the next taxable year is treated as a loss from a qualified trade or business.<sup>430</sup> Any deduction that would otherwise be allowed in a subsequent taxable year with respect to the taxpayer's qualified trades or businesses is reduced by 20 percent of any carryover qualified business loss.

#### *Reasonable Compensation and Guaranteed Payments*

Qualified business income excludes any amount paid by an S corporation that is treated as reasonable compensation of the taxpayer.<sup>431</sup> Similarly, qualified business income excludes any guaranteed payment for services rendered with respect to the trade or business,<sup>432</sup> and, to the extent provided in regulations, excludes any amount paid or incurred by a partnership to a partner, acting other than in his or her capacity as a partner, for services.<sup>433</sup>

#### *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.<sup>434</sup>

#### *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, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or 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, or which involves the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.<sup>435</sup> 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 section 475(c)(2) and (e)(2), respectively).

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<sup>430</sup> IRC section 199A(c)(2).

<sup>431</sup> IRC section 199A(c)(4).

<sup>432</sup> Described in IRC section 707(c).

<sup>433</sup> Described in IRC section 707(a).

<sup>434</sup> IRC section 199A(d)(1).

<sup>435</sup> IRC section 199A(d)(2).

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The exclusion from the definition of a qualified trade or 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) (together, the “threshold amount”), adjusted for inflation in taxable years beginning after 2018.<sup>436</sup> The exclusion from the definition of a qualified trade or 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).<sup>437</sup>

*Tentative Deductible Amount for a Qualified Trade or Business*

*In General*

For a taxpayer with taxable income below the threshold amount, the deductible amount for each qualified trade or business is equal to 20 percent of the qualified business income with respect to the trade or business.<sup>438</sup> For a taxpayer with taxable income above the threshold, the taxpayer is allowed a deductible amount for each qualified trade or business equal to the lesser of (1) 20 percent of the qualified business income with respect to such trade or business, or (2) 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 paid with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property of the qualified trade or business.<sup>439</sup>

*Limitations Based on W-2 Wages and Capital*

The wage and capital limitations phase in for a taxpayer with taxable income in excess of the threshold amount.<sup>440</sup> The wage and capital limitations apply fully for a taxpayer with taxable income in excess of the threshold amount plus \$50,000 (\$100,000 in the case of a joint return).

W-2 wages are the total wages subject to wage withholding,<sup>441</sup> elective deferrals,<sup>442</sup> and deferred compensation<sup>443</sup> paid by the qualified trade or business with respect to employment of its employees during the calendar year ending during the taxpayer’s taxable year.<sup>444</sup> 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 for the taxable year is taxable under IRC section 1 (income tax rates for individuals), the determination of W-2 wages with respect to the taxpayer’s

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<sup>436</sup> IRC section 199A(e)(2).

<sup>437</sup> See IRC section 199A(d)(3).

<sup>438</sup> IRC section 199A(b)(3).

<sup>439</sup> IRC section 199A(b)(2).

<sup>440</sup> See IRC section 199A(b)(3)(B).

<sup>441</sup> Defined in IRC section 3401(a).

<sup>442</sup> Within the meaning of IRC section 402(g)(3).

<sup>443</sup> Deferred compensation includes compensation deferred under IRC section 457, as well as the amount of any designated Roth contributions (as defined in IRC section 402A).

<sup>444</sup> IRC section 199A(b)(4). In the case of a taxpayer with a short taxable year that does not contain a calendar year ending during such short taxable year, the following amounts are treated as the W-2 wages of the taxpayer for the short taxable year: (1) wages paid during the short taxable year to employees of the qualified trade or business; (2) elective deferrals (within the meaning of IRC section 402(g)(3)) made during the short taxable year by employees of the qualified trade or business; and (3) compensation actually deferred under IRC section 457 during the short taxable year with respect to employees of the qualified trade or business. Amounts that are treated as W-2 wages for a taxable year are not treated as W-2 wages of any other taxable year. See Conference Report to accompany H.R. 1, Tax Cuts and Jobs Act, H.R. Rep. No. 115-466, December 15, 2017, p. 217.



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trade or business conducted in Puerto Rico is made without regard to any exclusion under the wage withholding rules<sup>445</sup> for remuneration paid for services in Puerto Rico. W-2 wages excludes any amount that is not properly allocable to qualified business income as a qualified item of deduction.<sup>446</sup> In addition, W-2 wages excludes any amount that was not properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for such return.<sup>447</sup>

Qualified property means tangible property subject to depreciation under IRC section 167 that is held by, and available for use in, the qualified trade or business at the close of the taxable year, is used at any point during the taxable year in the production of qualified business income, and for which the depreciable period ends after the close of the taxable year.<sup>448</sup> 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 that is 10 years after the date the property is first placed in service, 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 (determined without regard to IRC section 168(g)).

#### *Partnerships and S Corporations*

In the case of a partnership or S corporation, the IRC section 199A deduction is determined at the partner or shareholder level. Each partner in a partnership 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 and unadjusted basis of qualified property for the taxable year equal to the partner's allocable share of W-2 wages and unadjusted basis of qualified property of the partnership. The partner's allocable share of W-2 wages and unadjusted basis of qualified property are required to be determined in the same manner as the partner's allocable share of wage expenses and depreciation, respectively. 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 of the S corporation, and is treated as having W-2 wages and unadjusted basis of qualified property for the taxable year equal to the shareholder's pro rata share of W-2 wages and unadjusted basis of qualified property of the S corporation.

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

A deduction is allowed 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.<sup>449</sup>

Qualified REIT dividends excludes any portion of a dividend received from a REIT that is a capital gain dividend<sup>450</sup> or a qualified dividend.<sup>451</sup>

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<sup>445</sup> As provided in IRC section 3401(a)(8).

<sup>446</sup> IRC section 199A(b)(4)(B).

<sup>447</sup> IRC section 199A(b)(4)(C).

<sup>448</sup> IRC section 199A(b)(6).

<sup>449</sup> See IRC section 199A(a) and (b).

<sup>450</sup> Defined in IRC section 857(b)(3).

<sup>451</sup> Defined in IRC section 1(h)(11). See IRC section 199A(e)(3).



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A qualified cooperative dividend means any patronage dividend,<sup>452</sup> per-unit retain allocation,<sup>453</sup> qualified written notice of allocation,<sup>454</sup> or any other similar amount, provided such amount is includible in gross income and is received from either (1) a tax-exempt organization described in IRC section 501(c)(12)<sup>455</sup> 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.<sup>456</sup>

Qualified publicly traded partnership income means (with respect to any qualified trade or business of the taxpayer) the sum of (a) the net amount of the taxpayer's allocable share of each qualified item of income, gain, deduction, and loss of the partnership from a publicly traded partnership not treated as a corporation,<sup>457</sup> and (b) gain recognized by the taxpayer on disposition of its interest in such partnership that is treated as ordinary income (for example, by reason of IRC section 751).<sup>458</sup>

### *Determination of the Taxpayer's Deduction*

The taxpayer's deduction for qualified business income for the taxable year is equal to the sum of (1) the lesser of (a) the combined qualified business income amount for the taxable year, or (b) an amount equal to 20 percent of taxable income (reduced by any net capital gain<sup>459</sup> and qualified cooperative dividends), plus (2) the lesser of (a) 20 percent of qualified cooperative dividends, or (b) 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).<sup>460</sup> 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.<sup>461</sup>

The taxpayer's deduction for qualified business income is excluded from the computation of AGI; instead, the deduction is allowed in computing taxable income.<sup>462</sup> The deduction is available to individuals without regard to whether or not they itemize their deductions.<sup>463</sup>

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<sup>452</sup> Defined in IRC section 1388(a).

<sup>453</sup> Defined in IRC section 1388(f).

<sup>454</sup> Defined in IRC section 1388(c).

<sup>455</sup> Organizations described in IRC section 501(c)(12) are benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations; but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses. IRC section 501(c)(12)(A).

<sup>456</sup> IRC section 199A(e)(4).

<sup>457</sup> Such items must be effectively connected with a U.S. trade or business, be included or allowed in determining taxable income for the taxable year, and not constitute excepted enumerated investment-type income. Such items do not include the taxpayer's reasonable compensation, guaranteed payments for services, or (to the extent provided in regulations) IRC section 707(a) payments for services.

<sup>458</sup> IRC section 199A(e)(5).

<sup>459</sup> Defined in IRC section 1(h).

<sup>460</sup> IRC section 199A(a).

<sup>461</sup> IRC section 199A(b)(1).

<sup>462</sup> IRC section 62(a).

<sup>463</sup> IRC section 63(b) and (d).

## Present Law Treatment of Cooperatives and Their Patrons

### *In General*

Certain corporations are eligible to be treated as cooperatives and taxed under the special rules of subchapter T of the IRC.<sup>464</sup> In general, the subchapter T rules apply to any corporation operating on a cooperative basis (except mutual savings banks, insurance companies, most tax-exempt organizations, and certain utilities).

For federal income tax purposes, a cooperative subject to the cooperative tax rules of subchapter T generally computes its income as if it were a taxable corporation, except that, in determining its taxable income, the cooperative excludes amounts paid for the taxable year as (1) patronage dividends, to the extent paid in money, qualified written notices of allocation,<sup>465</sup> or other property (except nonqualified written notices of allocation)<sup>466</sup> with respect to patronage occurring during such taxable year, and (2) per-unit retain allocations, to the extent paid in money, qualified per-unit retain certificates,<sup>467</sup> or other property (except nonqualified per-unit retain certificates)<sup>468</sup> with respect to marketing occurring during such taxable year.<sup>469</sup>

Patronage dividends are amounts paid to a patron (1) on the basis of quantity or value of business done with or for such patron, (2) under an obligation of the cooperative to pay such amount that existed before the cooperative received the amount so paid, and (3) are determined by reference to the net earnings of the cooperative from business done with or for its patrons.<sup>470</sup> Per-unit retain allocations are allocations to a patron with respect to products marketed for that patron, the amount of which is fixed without reference to the net earnings of the organization pursuant to an agreement between the organization and the patron.<sup>471</sup>

Because a patron of a cooperative that receives patronage dividends or per-unit retain allocations generally must include such amounts in gross income,<sup>472</sup> excluding patronage dividends and per-unit retain allocations paid by the cooperative from the cooperative's taxable income in effect allows the cooperative to be a conduit with respect to profits derived from transactions with its patrons.

### *Specified Agricultural or Horticultural Cooperatives with Qualified Business Income*

For taxable years beginning after December 31, 2017, and before January 1, 2026, a deduction is allowed to any specified agricultural or horticultural cooperative equal to the lesser of (a)

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<sup>464</sup> IRC sections 1381-1388.

<sup>465</sup> As defined in IRC section 1388(c).

<sup>466</sup> As defined in IRC section 1388(d).

<sup>467</sup> As defined in IRC section 1388(h).

<sup>468</sup> As defined in IRC section 1388(i).

<sup>469</sup> IRC section 1382(b)(1) and (3). In determining its taxable income, the cooperative also does not take into account amounts paid in money or other property in redemption of a nonqualified written notice of allocation which was paid as a patronage dividend during the payment period for the taxable year during which the patronage occurred, or in redemption of a nonqualified per-unit retain certificate which was paid as a per-unit retain allocation during the payment period for the taxable year during which the marketing occurred. IRC section 1382(b)(2) and (4).

<sup>470</sup> IRC section 1388(a).

<sup>471</sup> IRC section 1388(f).

<sup>472</sup> IRC section 1385(a)(1) and (3).

20 percent of the excess (if any) of the cooperative's gross income over the qualified cooperative dividends paid during the taxable year 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.<sup>473</sup> The cooperative's IRC section 199A(g) deduction may not exceed its taxable income<sup>474</sup> for the taxable year.

A specified agricultural or horticultural cooperative is an organization to which part I of subchapter T applies that is engaged in (a) the manufacturing, production, growth, or extraction in 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.

#### New Federal Law (IRC section 199A and former IRC section 199)

### **1. Treatment of Specified Agricultural or Horticultural Cooperatives**

#### *Deduction for Qualified Production Activities Income*

The provision modifies the deduction for qualified business income of a specified agricultural or horticultural cooperative under IRC section 199A(g) to instead provide a deduction for qualified production activities income of a specified agricultural or horticultural cooperative that is similar to the deduction for qualified production activities income under former IRC section 199.

The provision provides a deduction from taxable income that is equal to nine percent of the lesser of the cooperative's qualified production activities income or taxable income (determined without regard to the cooperative's IRC section 199A(g) deduction and any deduction allowable under IRC section 1382(b) and (c) (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions)) for the taxable year. The amount of the deduction for a taxable year is limited to 50 percent of the W-2 wages paid by the cooperative during the calendar year that ends in such taxable year. For this purpose, W-2 wages are determined in the same manner as under the other provisions of IRC section 199A, except that such wages do not include any amount that is excluded from domestic production gross receipts.<sup>475</sup>

In the case of oil related qualified production activities income, the provision specifies that the IRC section 199A(g) deduction is reduced by three percent of the least of the cooperative's oil related qualified production activities income, qualified production activities income, or taxable income (determined without regard to the cooperative's IRC section 199A(g) deduction and any deduction allowable under IRC section 1382(b) and (c) (relating to patronage dividends, per-unit

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<sup>473</sup> IRC section 199A(g).

<sup>474</sup> For this purpose, taxable income is computed without regard to the cooperative's deduction under IRC section 199A(g).

<sup>475</sup> Under the provision, because Puerto Rico is not treated as part of the U.S. for purposes of determining domestic production gross receipts under IRC section 199A(g), W-2 wages do not include any remuneration paid for services in Puerto Rico.

retain allocations, and nonpatronage distributions)) for the taxable year. For this purpose, oil related qualified production activities income for any taxable year is the portion of qualified production activities income attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof<sup>476</sup> during the taxable year.

In general, qualified production activities income is equal to domestic production gross receipts reduced by the sum of: (1) the cost of goods sold that are allocable to such receipts;<sup>477</sup> and (2) other expenses, losses, or deductions that are properly allocable to such receipts.<sup>478</sup>

Domestic production gross receipts generally are the cooperative's gross receipts derived from any lease, rental, license, sale, exchange, or other disposition of any agricultural or horticultural product<sup>479</sup> that was manufactured, produced, grown, or extracted by the cooperative in whole or in significant part within the U.S.<sup>480</sup> The cooperative is treated as having manufactured, produced, grown, or extracted in whole or significant part any agricultural or horticultural products marketed by the cooperative if such items were manufactured, produced, grown, or extracted in whole or significant part by its patrons.

Domestic production gross receipts do not include any gross receipts of the cooperative derived from property leased, licensed, or rented by the taxpayer for use by any related person.<sup>481</sup> In addition, domestic production gross receipts do not include gross receipts that are derived from the lease, rental, license, sale, exchange, or other disposition of land.

#### *Definition of Specified Agricultural or Horticultural Cooperative*

The provision limits the definition of specified agricultural or horticultural cooperative to organizations to which part I of subchapter T applies that (1) manufacture, produce, grow, or extract in whole or significant part any agricultural or horticultural product; or (2) is a marketing cooperative of any agricultural or horticultural product and is considered to be conducting that activity of their patrons, e.g., manufacturing, producing, growing, or extracting in whole or

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<sup>476</sup> Within the meaning of IRC section 927(a)(2)(C) as in effect before its repeal.

<sup>477</sup> For this purpose, any item or service brought into the U.S. is treated as acquired by purchase, and its cost is treated as not less than its value immediately after it entered the U.S. A similar rule applies in determining the adjusted basis of leased or rented property where the lease or rental gives rise to domestic production gross receipts. In addition, for any property exported by the cooperative for further manufacture, the increase in cost or adjusted basis may not exceed the difference between the value of the property when exported and the value of the property when brought back into the U.S. after the further manufacture.

<sup>478</sup> In computing qualified production activities income, the IRC section 199A(g) deduction itself is not an allocable deduction. As under former IRC section 199, the cooperative's qualified production activities income is determined without regard to any deduction allowable under IRC section 1382(b) and (c) (relating to patronage dividends, per-unit retain allocations, and nonpatronage distributions). See Treas. Reg. section 1.199-6(c).

<sup>479</sup> Consistent with former IRC section 199, it is intended that 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. See Treas. Reg. section 1.199-6(f).

<sup>480</sup> Consistent with former IRC section 199, it is intended that domestic production gross receipts include gross receipts of a cooperative derived from any sale, exchange, or other disposition of agricultural products with respect to which the cooperative performs storage, handling, or other processing activities (other than transportation activities) within the U.S., provided such products are consumed in connection with, or incorporated into, the manufacturing, production, growth, or extraction of agricultural or horticultural products (whether or not by the cooperative). See Treas. Reg. section 1.199-3(e)(1).

<sup>481</sup> For this purpose, a person is treated as related to another person if such persons are treated as a single employer under subsection (a) or (b) of IRC section 52 or subsection (m) or (o) of IRC section 414, except that determinations under subsections (a) and (b) of IRC section 52 are made without regard to IRC section 1563(b).

significant part.<sup>482</sup> The definition no longer includes a cooperative solely engaged in the provision of supplies, equipment, or services to farmers or other specified agricultural or horticultural cooperatives.

### *Special Rules*

All members of an expanded affiliated group<sup>483</sup> are treated as a single corporation and the deduction is allocated among the members of the expanded affiliated group in proportion to each member's respective amount, if any, of qualified production activities income. In addition, for purposes of determining domestic production gross receipts, if all of the interests in the capital and profits of a partnership are owned by members of a single expanded affiliated group at all times during the taxable year of such partnership, the partnership and all members of such group are treated as a single taxpayer during such period.

In the case of a specified agricultural or horticultural cooperative that is a partner in a partnership, rules similar to the rules applicable to a partner in a partnership under IRC section 199A(f)(1) apply.

For a tax-exempt cooperative subject to tax on its unrelated business taxable income by IRC section 511, the provision is applied by substituting unrelated business taxable income for taxable income where applicable.

The IRC section 199A(g) deduction is determined by only taking into account items that are attributable to the actual conduct of a trade or business.

### *Allocation of the Cooperative's Deduction to Patrons*

IRC section 199A(g) specifies that an eligible patron that receives a qualified payment from a specified agricultural or horticultural cooperative is allowed as a deduction for the taxable year in which such payment is received an amount equal to the portion of the cooperative's deduction for qualified production activities income that is (1) allowed with respect to the portion of the qualified production activities income to which such payment is attributable, and (2) identified by the cooperative in a written notice mailed to the patron during the payment period described in IRC section 1382(d).<sup>484</sup>

The patron's deduction of such amount may not exceed the patron's taxable income for the taxable year (determined without regard to such deduction but after taking into account the patron's other deductions under IRC section 199A(a)). A qualified payment is any amount that

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<sup>482</sup> Consistent with former IRC section 199, it is intended that 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. See Treas. Reg. section 1.199-6(f).

<sup>483</sup> For this purpose, an expanded affiliated group is an affiliated group as defined in IRC section 1504(a) determined (1) by substituting "more than 50 percent" for "at least 80 percent" each place it appears, and (2) without regard to paragraphs (2) and (4) of IRC section 1504(b).

<sup>484</sup> Consistent with the allocation of the cooperative's deduction to its patrons under former IRC section 199 and consistent with the requirements for the payment of patronage dividends in IRC section 1388(a)(1), the cooperative's IRC section 199A(g) deduction is allocated among its patrons on the basis of the quantity or value of business done with or for such patron by the cooperative.

(1) is described in paragraph (1) or (3) of IRC section 1385(a) (*i.e.*, patronage dividends and per-unit retain allocations), (2) is received by an eligible patron from a specified agricultural or horticultural cooperative, and (3) is attributable to qualified production activities income with respect to which a deduction is allowed to such cooperative. An eligible patron is (1) a taxpayer other than a corporation,<sup>485</sup> or (2) another specified agricultural or horticultural cooperative.

Finally, the cooperative cannot reduce its income under IRC section 1382 for any deduction allowable to its patrons under this rule (*i.e.*, the cooperative must reduce its deductions allowed for certain payments to its patrons in an amount equal to the IRC section 199A(g) deduction allocated to its patrons).

### *Regulatory Authority*

Specific regulatory authority is provided for the Secretary of the Treasury to promulgate necessary regulations under IRC section 199A(g), including regulations that prevent more than one cooperative taxpayer from being allowed a deduction with respect to the same activity (*i.e.*, the same lease, rental, license, sale, exchange, or other disposition of any agricultural or horticultural product that was manufactured, produced, grown, or extracted in whole or in significant part within the U.S.). In addition, regulatory authority is provided to address the proper allocation of items of income, deduction, expense, and loss for purposes of determining qualified production activities income. The provision specifies that the regulations be based on the regulations applicable to cooperatives and their patrons under former IRC section 199 (as in effect before its repeal).<sup>486</sup>

## **2. Treatment of Cooperative Patrons**

### *Repeal of Special Deduction for Qualified Cooperative Dividends*

The provision repeals the special deduction for qualified cooperative dividends and the rule that excludes qualified cooperative dividends from qualified business income of a qualified trade or business. The provision also clarifies that items of income excluded from qualified items of income, and thus excluded from qualified business income, do not include any amount described in IRC section 1385(a)(1) (*i.e.*, patronage dividends).

Accordingly, qualified business income of a qualified trade or business includes any patronage dividend,<sup>487</sup> per-unit retain allocation,<sup>488</sup> qualified written notice of allocation,<sup>489</sup> or any other similar amount received from a cooperative, provided such amount is otherwise a qualified item of income, gain, deduction, or loss (*i.e.*, such amount is (1) effectively connected with the conduct of a trade or business within the U.S., and (2) included or allowed in determining taxable income for the taxable year).<sup>490</sup>

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<sup>485</sup> For this purpose, corporation does not include an S corporation.

<sup>486</sup> See Treas. Reg. sections 1.199-1 through 9.

<sup>487</sup> Defined in IRC section 1388(a).

<sup>488</sup> Defined in IRC section 1388(f).

<sup>489</sup> Defined in IRC section 1388(c).

<sup>490</sup> See IRC section 199A(c)(3)(A).



*Reduced Deduction for Qualified Payments Received from a Specified Agricultural or Horticultural Cooperative*

In the case of any qualified trade or business of a patron of a specified agricultural or horticultural cooperative, the deductible amount determined under IRC section 199A(b)(2) for such trade or business is reduced by the lesser of (1) nine percent of the amount of qualified business income with respect to such trade or business as is properly allocable to qualified payments received from such specified agricultural or horticultural cooperative, or (2) 50 percent of the amount of W-2 wages with respect to such qualified trade or business that are properly allocable to such amount.

**3. Transition Rule Relating to the Repeal of IRC Section 199**

The provision clarifies that the repeal of IRC section 199 for taxable years beginning after December 31, 2017, does not apply to a qualified payment received by a patron from a specified agricultural or horticultural cooperative in a taxable year beginning after December 31, 2017, to the extent such qualified payment is attributable to qualified production activities income with respect to which a deduction is allowable to the cooperative under former IRC section 199 for a taxable year of the cooperative beginning before January 1, 2018. Such qualified payment remains subject to former IRC section 199 and any IRC section 199 deduction allocated by the cooperative to its patrons related to such qualified payment may be deducted by such patrons in accordance with former IRC section 199. In addition, no deduction is allowed under IRC section 199A for such qualified payments.

**4. Examples**

The following examples illustrate the provision.

*Example 1*

Cooperative is a grain marketing cooperative with \$5,250,000 in gross receipts during 2018 from the sale of grain grown by its patrons. Cooperative paid \$4,000,000 to its patrons at the time the grain was delivered in the form of per-unit retain allocations and another \$1,000,000 in patronage dividends after the close of the 2018 taxable year. Cooperative has other expenses of \$250,000 during 2018, including \$100,000 of W-2 wages.

Cooperative has domestic production gross receipts of \$5,250,000 and qualified production activities income of \$5,000,000<sup>491</sup> for 2018. Cooperative's IRC section 199A(g) deduction is \$50,000 and is equal to the least of nine percent of qualified production activities income (\$450,000),<sup>492</sup> nine percent of taxable income (\$450,000),<sup>493</sup> or 50 percent of W-2 wages (\$50,000).<sup>494</sup> Cooperative passes through the entire IRC section 199A(g) deduction to its patrons. Accordingly, Cooperative reduces its \$5,000,000 deduction allowable under IRC section 1382(b)

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<sup>491</sup> \$5,250,000 gross receipts - \$250,000 expenses = \$5,000,000.

<sup>492</sup> \$5,000,000 \* .09 = \$450,000.

<sup>493</sup> For this purpose, taxable income is \$5,000,000 and is determined without regarding to the IRC section 199A(g) deduction and without regard to the \$5,000,000 deduction allowable under IRC section 1382(b) and (c) relating to the \$1,000,000 patronage dividends and \$4,000,000 per-unit retain allocations.

<sup>494</sup> \$100,000 \* .5 = \$50,000.



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and (c) (relating to the \$1,000,000 patronage dividends and \$4,000,000 per-unit retain allocations) by \$50,000.

Patron's grain delivered to Cooperative during 2018 is two percent of all grain marketed through Cooperative during such year. During 2019, Patron receives \$20,000 in patronage dividends and \$1,000 of allocated IRC section 199A(g) deduction from Cooperative related to the grain delivered to Cooperative during 2018.

Patron is a grain farmer with taxable income of \$75,000 for 2019 (determined without regard to IRC section 199A) and has a filing status of married filing jointly. Patron's qualified business income related to its grain trade or business for 2019 is \$50,000, which consists of gross receipts of \$150,000 from sales to an independent grain elevator, per-unit retain allocations received from Cooperative during 2019 of \$80,000, patronage dividends received from Cooperative during 2019 related to Cooperative's 2018 net earnings of \$20,000, and expenses of \$200,000 (including \$50,000 of W-2 wages).

The portion of the qualified business income from Patron's grain trade or business related to qualified payments received from Cooperative during 2019 is \$10,000, which consists of per-unit retain allocations received from Cooperative during 2019 of \$80,000, patronage dividends received from Cooperative during 2019 related to Cooperative's 2018 net earnings of \$20,000, and properly allocable expenses of \$90,000 (including \$25,000 of W-2 wages).<sup>495</sup>

Patron's deductible amount related to the grain trade or business is 20 percent of qualified business income (\$10,000)<sup>496</sup> reduced by the lesser of nine percent of qualified business income related to qualified payments received from Cooperative (\$900)<sup>497</sup> or 50 percent of W-2 wages related to qualified payments received from Cooperative (\$12,500),<sup>498</sup> or \$9,100. As Patron does not have any other qualified trades or business, the combined qualified business income amount is also \$9,100.

Patron's deduction under IRC section 199A for 2019 is \$10,100, which consists of the combined qualified business income amount of \$9,100, plus Patron's deduction passed through from Cooperative of \$1,000.

### *Example 2*

Cooperative and Patron have the same facts as above for 2018 and 2019 except that Patron has expenses of \$200,000 that include zero W-2 wages during 2019.

Patron's deductible amount related to the grain trade or business is 20 percent of qualified business income (\$10,000) reduced by the lesser of nine percent of qualified business income

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<sup>495</sup> Which expenses are properly allocable in a given case will depend on all the facts and circumstances. The example assumes that the fraction of properly allocable W-2 wages differs from the fraction of other properly allocable expenses.

<sup>496</sup>  $\$50,000 * .2 = \$10,000$ .

<sup>497</sup>  $\$10,000 * .09 = \$900$ .

<sup>498</sup>  $\$25,000 * .5 = \$12,500$ .

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related to qualified payments received from Cooperative (\$900), or 50 percent of W-2 wages related to qualified payments received from Cooperative (\$0), or \$10,000.

Patron's deduction under IRC section 199A for 2019 is \$11,000, which consists of the combined qualified business income amount of \$10,000, plus Patron's deduction passed through from Cooperative of \$1,000.

Effective Dates

The provision is effective as if included in the amendments made by sections 11011 and 13305 of Public Law 115-97, that is, for taxable years beginning after December 31, 2017.

California Law (R&TC sections 17201, 17201.6, and 24404-24406.6)

California does not conform, under the PITL, to the federal deduction for qualified business income of pass-through entities under IRC section 199A, nor to the federal change which modifies the deduction for qualified business income of a specified agricultural or horticultural cooperative under IRC section 199A(g) to instead provide a deduction for qualified production activities income of a specified agricultural or horticultural cooperative which is similar to the deduction for qualified production activities income under former IRC section 199.

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 change that makes the IRC section 199 repeal inapplicable to a qualified payment received by a patron from a specified agricultural or horticultural cooperative, does not apply for California purposes.

California has its own stand-alone rules relating to the special deductions allowed under the CTL for corporations formed and operating on a cooperative basis.

*Farmer's Cooperative Associations*

This group of cooperatives is entitled to a deduction for "all income resulting from, or arising out of business activities for or with their members, carried on by them or their agents or when done on a nonprofit basis for or with non-members." The amounts allocated to members include capital stock, as well as cash, merchandise, revolving fund certificates, certificates of indebtedness, retain certificates, letters of advice or written instruments which in some other manner disclose to each member the dollar amount allocated to him or her.

*Other Cooperatives*

All other cooperatives are allowed to deduct only patronage refunds.

### *Cooperative Dividends*

To the extent provided in organizational documents of the cooperative, dividends on capital stock won't reduce patronage income or prevent the cooperative from being treated as operating on a cooperative basis.<sup>499</sup>

### Impact on California Revenue

Not applicable.

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<u>Sections</u>	<u>Section Title</u>
102, 103	Low-Income Housing Credit Ceiling and Average Income Test

### Background

The federal low-income housing credit may be claimed over a 10-year credit period after each low-income building is placed in service. The amount of the credit for any taxable year in the credit period is the applicable percentage of the qualified basis of each qualified low-income building. A state housing credit ceiling applies. For determining the current-year state dollar amount of the ceiling in any calendar year, the greater of (1) \$1.75 multiplied by the state population, or (2) \$2,000,000, is taken into account. These amounts are indexed for inflation. For calendar year 2018, the amounts are \$2.40 and \$2,760,000.

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

A unit occupied by individuals whose incomes rise above 140 percent of the applicable income limit shall continue to be treated as a low-income unit if the income of such occupants initially met such income limitation and such unit continues to be rent-restricted so long as the next available unit is occupied by a tenant whose income does not exceed such limitation. In the case of deep rent skewed projects, special rules apply. A deep rent skewed project is a project in which (1) 15 percent or more of the low-income units in the project are occupied by individuals whose incomes are 40 percent or less of area median gross income, (2) the gross rent with respect to each low-income unit in the project does not exceed 30 percent of the applicable income limit that applies to individuals occupying the unit, and (3) the gross rent with respect to each low-income

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<sup>499</sup> R&TC section 24406.6.

unit in the project does not exceed the average gross rent with respect to units of comparable size that are not occupied by individuals who meet the applicable income limit.

New Federal Law (IRC section 42)

**State Housing Credit Ceiling**

The provision increases the state housing credit ceiling for 2018, 2019, 2020, and 2021. In each of those calendar years, the dollar amounts in effect for determining the current-year ceiling (after any increase due to the applicable cost of living adjustment) are increased by multiplying the dollar amounts for that year by 1.125.

**Average Income Test for Qualified Low-Income Housing Project**

The provision adds a third optional test to the 20-50 and 40-60 tests for a qualified low-income housing project. A project meets the minimum requirements of the average income test if 40 percent or more (25 percent or more in the case of a project located in a high cost housing area) of the residential units in such project are both rent-restricted and occupied by individuals whose income does not exceed the imputed income limitation as designated by the taxpayer for the respective unit.

The imputed income limitation may be designated as 20, 30, 40, 50, 60, 70, or 80 percent. The average of the imputed income limitations designated must not exceed 60 percent of area median gross income.

For purposes of the rental of the next available unit in a project with respect to which the taxpayer elects the average income test, if the income of the occupants of the unit increases above 140 percent of the greater of (1) 60 percent of area median gross income, or (2) the imputed income limitation designated by the taxpayer with respect to the unit, then the unit ceases to be treated as a low-income unit if any residential rental unit in the building (of a size comparable to, or smaller than, such unit) is occupied by a new resident whose income exceeds the applicable imputed income limitation. In the case of a deep rent skewed project, 170 percent applies instead of 140 percent, and other special rules apply.

Effective Dates

The provision relating to the state housing credit ceiling is effective for calendar years beginning after December 31, 2017.

The provision relating to the average income test is effective for elections made after the date of enactment, March 23, 2018.

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California Law (R&TC sections 17057.5, 17058, 23610.4, and 23610.5)

California generally conforms, under the PITL and the CTL, to the low-income housing credit under IRC section 42<sup>500</sup> as of the specified date of January 1, 2015,<sup>501</sup> with modifications. California did not conform to the federal changes that increased the state housing credit ceiling and added a third optional test for a qualified low-income housing project.

Additionally, California does not conform to the federal provision<sup>502</sup> that makes permanent the special rule that the military basic housing allowance is not included in income for purposes of the low-income housing credit income eligibility rules.

*California Low-Income Housing Credit*

California's low-income housing credit is modified to provide that the applicable percentage for newly-constructed non-federally subsidized buildings for the first three years is the percentage prescribed by the Secretary of the Treasury for the taxable year, and for the fourth year, the percentage is the difference between 30 percent and the sum of the credit percentages for the first three years.<sup>503</sup> Additional California modifications are described below.

In order to qualify for the California low-income housing credit, the low-income housing project must be located in California.

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

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

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

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

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<sup>500</sup> R&TC sections 17058 and 23610.5.

<sup>501</sup> R&TC section 17024.5 and 23051.5.

<sup>502</sup> Section 132, PATH Act, Public Law 114-113, enacted December 18, 2015.

<sup>503</sup> R&TC sections 17058(c)(2) and 23610.5(c)(2).

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California modifies the federal rule for the increase in qualified basis after the first year of the credit period.<sup>504</sup> When the basis of a building that has been granted a low-income housing tax credit is increased and exceeds the basis at the end of the first year of the four-year credit period, the taxpayer is eligible for a credit on the excess basis. This additional credit is also taken over a four-year period beginning with the taxable year in which the increase in qualified basis occurs.

For partnership allocations of low-income housing credits occurring on or after January 1, 2009, and before January 1, 2020, the credit must be allocated to the partners of a partnership owning the project based on the partnership agreement, regardless of how the federal credit is allocated and whether the allocation of the credit under the partnership agreement has “substantial economic effect” within the meaning of IRC section 704(b). To the extent the allocation of the credit to a partner lacks substantial economic effect, any loss or deduction attributable to the sale, transfer, exchange, abandonment, or any other disposition of a partnership interest prior to the federal credit’s expiration is deferred and treated as if it occurred in the first taxable year immediately following the taxable year in which the federal credit period expires.<sup>505</sup>

Beginning on or after January 1, 2016, and before January 1, 2020, California allows a taxpayer that is allowed a low-income housing tax credit to elect to sell all or a portion of that credit to one or more unrelated parties, for each taxable year in which the credit is allowed, for not less than 80 percent of the amount of the credit to be sold, and provides for a one-time resale of that credit.

Impact on California Revenue

**Low-Income Housing Credit Ceiling**

Not applicable.

**Average Income Test for Qualified Low-Income Housing Project**

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Estimated Conformity Revenue Impact of Average Income Test for Qualified Low-Income Housing Project For Taxable Years Beginning On or After January 1, 2019 Enactment Assumed After June 30, 2019			
2018-19	2019-20	2020-21	2021-22
\$N/A	(\$250,000)	(\$300,000)	(\$450,000)

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<sup>504</sup> IRC section 42(f)(3).

<sup>505</sup> R&TC sections 17058(b)(1)(C) and 23610.5(b)(1)(C).

**Division U, Title I—Tax Technical Corrections**

<u>Section</u>	<u>Section Title</u>
101	Amendments Relating to the PATH Act <sup>506</sup>

a. Earned Income Tax Credit Permanent Rules (PATH Act section 103)

Background

**Overview**

Low- and moderate-income workers may be eligible for the refundable earned income tax credit (EITC). Eligibility for the EITC is based on earned income, AGI, investment income, filing status, number of children, and immigration and work status in the U.S. The amount of the EITC is based on the presence and number of qualifying children in the worker's family, as well as on AGI and earned income.

The EITC generally equals a specified percentage of earned income up to a maximum dollar amount. The maximum amount applies over a certain income range and then diminishes to zero over a specified phase-out range. For taxpayers with earned income (or AGI, if greater) in excess of the beginning of the phase-out range, the maximum EITC amount is reduced by the phase-out rate multiplied by the amount of earned income (or AGI, if greater) in excess of the beginning of the phase-out range. For taxpayers with earned income (or AGI, if greater) in excess of the end of the phase-out range, no credit is allowed.

An individual is ineligible for the EITC if the aggregate amount of the individual's disqualified income for the taxable year exceeds \$3,500 (for 2018). This threshold is indexed for inflation. Disqualified income is the sum of: (1) interest (both taxable and tax exempt); (2) dividends; (3) net rent and royalty income (if greater than zero); (4) capital gains net income; and (5) net passive income other than self-employment income (if greater than zero).

The EITC is a refundable credit, meaning that if the amount of the credit exceeds the taxpayer's federal income tax liability, the excess is payable to the taxpayer as a direct transfer payment.

**Filing Status**

An unmarried individual may claim the EITC if he or she files as a single filer or as a head of household. Married individuals generally may not claim the EITC unless they file jointly. An exception to the joint return filing requirement applies to certain spouses who are separated. Under this exception, a married taxpayer who is separated from his or her spouse for the last six months of the taxable year is not considered to be married (and, accordingly, may file a return as head of household and claim the EITC), provided that the taxpayer maintains a household that constitutes the principal place of abode for a dependent child (including a son, stepson, daughter,

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<sup>506</sup> Public Law 114-113, enacted December 18, 2015.



stepdaughter, adopted child, or a foster child) for over half the taxable year, and pays over half the cost of maintaining the household in which he or she resides with the child during the year.

### Presence of Qualifying Children and Amount of the Earned Income Tax Credit

Four separate credit schedules apply: one for taxpayers with no qualifying children, a second for taxpayers with one qualifying child, a third for taxpayers with two qualifying children, and a fourth for taxpayers with three or more qualifying children.<sup>507</sup>

Taxpayers with no qualifying children may claim a credit if they are over age 24 and below age 65. The credit is 7.65 percent of earnings up to \$6,780, resulting in a maximum credit of \$519 for 2018. The maximum is available for those with incomes between \$6,780 and \$8,490 (\$14,170 if married filing jointly). The credit begins to phase out at a rate of 7.65 percent of earnings above \$8,490 (\$14,170 if married filing jointly) resulting in a \$0 credit at \$15,270 of earnings (\$20,950 if married filing jointly).

Taxpayers with one qualifying child may claim a credit in 2018 of 34 percent of their earnings up to \$10,180, resulting in a maximum credit of \$3,461. The maximum credit is available for those with earnings between \$10,180 and \$18,660 (\$24,350 if married filing jointly).

The credit begins to phase out at a rate of 15.98 percent of earnings above \$18,660 (\$24,350 if married filing jointly). The credit is completely phased out at \$40,320 of earnings (\$46,010 if married filing jointly).

Taxpayers with two qualifying children may claim a credit in 2018 of 40 percent of earnings up to \$14,290, resulting in a maximum credit of \$5,716. The maximum credit is available for those with earnings between \$14,290 and \$18,660 (\$24,350 if married filing jointly). The credit begins to phase out at a rate of 21.06 percent of earnings \$18,660 (\$24,350 if married filing jointly). The credit is completely phased out at \$45,802 of earnings (\$51,492 if married filing jointly).

Taxpayers with three or more qualifying children can claim a credit of 45 percent for taxable years through 2017. In addition, the higher phase-out thresholds for married couples to \$5,000 (indexed for inflation from 2009) above that for other filers applied through the 2016 calendar year.

If more than one taxpayer lives with a qualifying child, only one of these taxpayers may claim the child for purposes of the EITC. If multiple eligible taxpayers claim the same qualifying child, then a tiebreaker rule determines the taxpayer entitled to the EITC with respect to the qualifying child. Any eligible taxpayer with at least one qualifying child who does not claim the EITC with respect to qualifying children due to the failure to meet certain identification requirements with respect to such children (*i.e.*, providing the name, age and the individual taxpayer identification number (ITIN) of each of such children) is prohibited from claiming the EITC for taxpayers without qualifying children.

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<sup>507</sup> All income thresholds are indexed for inflation annually.

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New Federal Law (IRC section 32)

The provision removes the 2016 calendar year expiration date of the \$5,000 increase in the phase-out amount for married couples filing joint returns, making the increased phase-out amount permanent. In addition, the provision retains the rules for the indexation of the prior-law \$3,000 amount (notwithstanding that this amount had been repealed). Finally, the provision deletes references to the prior law amount and consolidates the inflation adjustment in one subsection.

Effective Dates

The amendments made by this section are effective as if included in the provision of the PATH Act to which they relate (applicable for taxable years beginning after December 18, 2015.)

California Law (R&TC section 17052)

California law provides a refundable California EITC that is generally determined in accordance with IRC section 32, as applicable for federal income tax purposes for the taxable year,<sup>508</sup> except as modified.<sup>509</sup>

California conforms to the federal requirement that an eligible individual and any qualifying child must have a valid SSN. California also conforms to the definitions of an “eligible individual” and a “qualifying child” with the following exceptions:

- An eligible individual without a qualifying child must have a principal place of abode in “this state” (rather than the U.S.) for more than one-half of the taxable year.
- A qualifying child also must have a principal place of abode in “this state” (rather than the U.S.) for more than one-half of the taxable year.

For purposes of the California EITC, the federal definition of “earned income” is modified to include wages, salaries, tips, and other employee compensation, includable in federal AGI, but only if such amounts are subject to California withholding.<sup>510</sup> For taxable years beginning on or after January 1, 2015, and before January 1, 2017, earned income specifically excluded net earnings from self-employment.

For taxable years beginning on or after January 1, 2017, the California EITC was modified to include, in the definition of earned income, net earnings from self-employment, consistent with federal law, and to increase the maximum AGI amounts at which the California EITC is completely phased-out.

For 2018, the California EITC is generally available to households with AGI of less than \$24,951.

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<sup>508</sup> Regardless of the specified date of January 1, 2015 under R&TC section 17024.5.

<sup>509</sup> R&TC section 17052. The California EITC is only operative for taxable years the annual Budget Act specifies an adjustment factor and authorizes resources for the FTB to oversee and audit returns associated with the California EITC. Refunds for the California EITC are paid from the continuously appropriated Tax Relief and Refund Account.

<sup>510</sup> Pursuant to Division 6 (commencing with section 13000) of the Unemployment Insurance Code.

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For taxable years beginning on or after January 1, 2018, the age limit for an eligible individual without a qualifying child is 18 years or older, rather than between the ages of 25 and 64 years.<sup>511</sup>

Additionally, California law provides that for taxable years beginning on or after January 1, 2018, and before January 1, 2019, the percentage change in the California Consumer Price Index (CCPI) would be deemed to be the greater of 3.1 percent or the percentage change in the CCPI as calculated under R&TC section 17041(h) for that taxable year.

For the 2018 taxable year, the California EITC percentages and phase-out amounts are:

An Eligible Individual with:	The Credit Percentage is:	The Phase-Out Percentage is:
No Qualifying Children	7.65%	7.65%
1 Qualifying Child	34%	34%
2 Qualifying Children	40%	40%
3 or More Qualifying Children	45%	45%

For the 2018 taxable year, if the credit amount calculated under the above table is less than \$103 for no qualifying children or less than \$258 for one or more qualifying children, the California EITC percentages and phase-out amounts are:

An Eligible Individual with:	The Credit Percentage is:	The Phase-Out Percentage is:
No Qualifying Children	2.20%	1.08%
1 Qualifying Child	3.10%	2.00%
2 Qualifying Children	2.13%	2.82%
3 or More Qualifying Children	2.12%	2.85%

<sup>511</sup> The eligible individual must not have attained age 65 before the close of the taxable year.

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The 2018 earned income, phase-out and maximum credit amounts are shown below (these amounts are indexed annually for inflation):

An Eligible Individual with:	Earned Income Amount (Maximum Credit Fully Phased-in)	Completely Phased-Out at:	2015 Maximum Credit (Before EITC Adjustment Factor)	2015 Maximum Credit (With 85% EITC Adjustment Factor)
No Qualifying Children	\$3,580	\$16,750	\$273	\$232
1 Qualifying Child	\$5,376	\$24,950	\$1,828	\$1,554
2 Qualifying Children	\$7,547	\$24,950	\$3,011	\$2,559
3 or More Qualifying Children	\$7,547	\$24,950	\$3,387	\$2,879

Impact on California Revenue

Not applicable.

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b. Transit Parity (PATH Act section 105)

Background

**Qualified Transportation Fringes**

Qualified transportation fringe benefits provided by an employer are excluded from an employee's gross income for income tax purposes and from an employee's wages for employment tax purposes.<sup>512</sup> Qualified transportation fringe benefits include parking, transit passes, vanpool benefits, and qualified bicycle commuting reimbursements.

No amount is includible in the income of an employee merely because the employer offers the employee a choice between cash and qualified transportation fringe benefits (other than a qualified bicycle commuting reimbursement).

Qualified transportation fringe benefits also include a cash reimbursement (under a bona fide reimbursement arrangement) by an employer to an employee for parking, transit passes, or vanpooling. In the case of transit passes, however, in general, a cash reimbursement is considered a qualified transportation fringe benefit only if a voucher, or similar item, that can be exchanged only for a transit pass, is not readily available for direct distribution by the employer to the employee.

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<sup>512</sup> IRC sections 132(a)(5) and (f), 3121(a)(20), 3231(e)(5), 3306(b)(16) and 3401(a)(19).

## Mass Transit Parity

The PATH Act reinstated parity by increasing the monthly exclusion for combined employer-provided transit pass and vanpool benefits and for employer-provided parking benefits, and makes parity permanent.<sup>513</sup> Thus, for 2015, the monthly limit on the exclusion for combined transit pass and vanpool benefits is \$250, the same as the monthly limit on the exclusion for qualified parking benefits. Similarly, for 2016 and later years, the same monthly limit will apply on the exclusion for combined transit pass and vanpool benefits and the exclusion for qualified parking benefits.

In order for the extension to be effective retroactive to January 1, 2015, expenses incurred for months beginning after December 31, 2014, and before enactment of the PATH Act, by an employee for employer-provided vanpool and transit benefits may be reimbursed (under a bona fide reimbursement arrangement) by employers on a tax-free basis to the extent they exceed \$130 per month and are no more than \$250 per month. It is intended that the rule that an employer reimbursement is excludible only if vouchers are unavailable to provide the benefit continues to apply, except in the case of reimbursements for vanpool or transit benefits between \$130 and \$250 for months beginning after December 31, 2014, and before enactment of the PATH Act. Further, it is intended that reimbursements of the additional amount for expenses incurred for months beginning after December 31, 2014, and before enactment of the PATH Act, may be made in addition to the provision of benefits or reimbursements of up to the applicable monthly limit for expenses incurred for months beginning after enactment of the PATH Act.

The PATH Act created permanent parity in the exclusions by changing the monthly transit/vanpooling limit in IRC section 132(f)(2) to \$175. However, the PATH Act failed to include a conforming change to repeal the base-year rule in IRC section 132(f)(6) for transit/vanpooling.

### New Federal Law (IRC section 132)

The provision repeals the transit/vanpooling base-year rule in IRC section 132(f)(6).

### Effective Dates

The amendments made by this section are effective as if included in the provision of the PATH Act to which they relate, effective for months beginning on or after February 17, 2009, and before January 1, 2015.

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<sup>513</sup> Parity was provided originally by the American Recovery and Reinvestment Act of 2009 (ARRA), Public Law 111-5, effective for months beginning on or after February 17, 2009, the date of enactment of ARRA.

California Law (R&TC sections 17131 and 17149)

California's PITL generally conforms to the federal rules for items specifically excluded from gross income as of the specified date of January 1, 2015,<sup>514</sup> and as a result conforms to the federal exclusion for qualified transportation fringe benefits under IRC section 132 as of that "specified date." However, the PITL additionally provides its own exclusion for qualified California transportation fringe benefits<sup>515</sup> that is not subject to a limitation; thus, while California does not conform to the parity in qualified transportation fringe benefits made permanent by this provision, the enhanced exclusion is allowable under current California law to the extent that the benefits are qualified California transportation benefits.

Impact on California Revenue

Baseline—although California does not conform to this provision because it was enacted after the "specified date," California's PITL allows an unlimited exclusion for qualified California transportation fringe benefits.<sup>516</sup> Thus, because some employers are expected to change the amount of transportation fringe benefits offered based on this federal extension of parity of qualified transportation fringe benefits, this provision is expected to result in a baseline revenue loss.

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c. Research Credit: Not Reinstate Alternative Incremental Credit (PATH Act section 121)

Background

**Research Credit**

*General Rule*

For general research expenditures, a taxpayer may claim a research credit equal to 20 percent of the amount by which the taxpayer's qualified research expenses for a taxable year exceed its base amount for that year.<sup>517</sup> Thus, the research credit is generally available with respect to incremental increases in qualified research. An alternative simplified credit (ASC), with a 14-percent rate—and a different base amount—may be claimed in lieu of this credit.<sup>518</sup>

A 20-percent research tax credit also is available with respect to the excess of (1) 100 percent of corporate cash expenses (including grants or contributions) paid for basic research conducted by

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<sup>514</sup> R&TC section 17131 conforms to Part III of Subchapter B of Chapter 1 of Subtitle A of the IRC, containing IRC sections 101 to 138, as of the specified date of January 1, 2015, with modifications.

<sup>515</sup> R&TC section 17149.

<sup>516</sup> If taxpayers have qualified California transportation fringe benefits that are excludable for state purposes, but not excludable for federal purposes because of the federal limitations, they report the state-only excludable amounts as California adjustments on Schedule CA (540/540NR).

<sup>517</sup> IRC section 41(a)(1).

<sup>518</sup> IRC section 41(c)(5).

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universities (and certain nonprofit scientific research organizations) over (2) the sum of (a) the greater of two minimum basic research floors plus (b) an amount reflecting any decrease in non-research giving to universities by the corporation as compared to such giving during a fixed-base period, as adjusted for inflation.<sup>519</sup> This separate credit computation is commonly referred to as the basic research credit.

Finally, a research credit is available for a taxpayer's expenditures on research undertaken by an energy research consortium.<sup>520</sup> This separate credit computation is commonly referred to as the energy research credit. Unlike the other research credits, the energy research credit applies to all qualified expenditures, not just those in excess of a base amount.

The PATH Act made the research credit, including the basic research credit and the energy research credit permanent.

#### *Computation of General Research Credit*

The general research tax credit applies only to the extent that the taxpayer's qualified research expenses for the current taxable year exceed its base amount. The base amount for the current year generally is computed by multiplying the taxpayer's fixed-base percentage by the average amount of the taxpayer's gross receipts for the four preceding years. If a taxpayer both incurred qualified research expenses and had gross receipts during each of at least three years from 1984 through 1988, then its fixed-base percentage is the ratio that its total qualified research expenses for the 1984-1988 period bears to its total gross receipts for that period (subject to a maximum fixed-base percentage of 16 percent). Special rules apply to all other taxpayers (so called start-up firms).<sup>521</sup> In computing the research credit, a taxpayer's base amount cannot be less than 50 percent of its current-year qualified research expenses.

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<sup>519</sup> IRC section 41(a)(2) and (e). The base period for the basic research credit generally extends from 1981 through 1983.

<sup>520</sup> IRC section 41(a)(3).

<sup>521</sup> The Small Business Job Protection Act of 1996 expanded the definition of start-up firms under IRC section 41(c)(3)(B)(i) to include any firm if the first taxable year in which such firm had both gross receipts and qualified research expenses began after 1983. A special rule (enacted in 1993) is designed to gradually re-compute a start-up firm's fixed-base percentage based on its actual research experience. Under this special rule, a start-up firm is assigned a fixed-base percentage of three percent for each of its first five taxable years after 1993 in which it incurs qualified research expenses. A start-up firm's fixed-base percentage for its sixth through tenth taxable years after 1993 in which it incurs qualified research expenses is a phased-in ratio based on the firm's actual research experience. For all subsequent taxable years, the taxpayer's fixed-base percentage is its actual ratio of qualified research expenses to gross receipts for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993. IRC section 41(c)(3)(B).



### *Alternative Simplified Credit*

The alternative simplified credit is equal to 14 percent of qualified research expenses that exceed 50 percent of the average qualified research expenses for the three preceding taxable years.<sup>522</sup> The rate is reduced to 6 percent if a taxpayer has no qualified research expenses in any one of the three preceding taxable years.<sup>523</sup> An election to use the alternative simplified credit applies to all succeeding taxable years unless revoked with the consent of the Secretary.<sup>524</sup>

### *Alternative Incremental Credit*

For taxable years beginning before January 1, 2009, taxpayers were allowed to elect an alternative incremental research credit regime.<sup>525</sup> A taxpayer electing this alternative regime was assigned a three-tiered fixed-base percentage (that was lower than the fixed-base percentage otherwise applicable) and the credit rate likewise was reduced.

Generally, for amounts paid or incurred prior to 2007, under the alternative incremental credit regime, a credit rate of 2.65 percent applied to the extent that a taxpayer's current-year research expenses exceeded a base amount computed by using a fixed-base percentage of one percent (i.e., the base amount equaled one percent of the taxpayer's average gross receipts for the four preceding years) but did not exceed a base amount computed by using a fixed-base percentage of 1.5 percent. A credit rate of 3.2 percent applied to the extent that a taxpayer's current-year research expenses exceeded a base amount computed by using a fixed-base percentage of 1.5 percent but did not exceed a base amount computed by using a fixed-base percentage of 2 percent. A credit rate of 3.75 percent applied to the extent that a taxpayer's current-year research expenses exceeded a base amount computed by using a fixed-base percentage of 2 percent. Generally, for amounts paid or incurred after 2006, the credit rates listed above were increased to three percent, four percent, and five percent, respectively.<sup>526</sup>

### *Eligible Expenses*

Qualified research expenses eligible for the research tax credit consist of: (1) the taxpayer's in-house expenses for wages and supplies attributable to qualified research; (2) certain time-sharing costs for computer use in qualified research; and (3) 65 percent of amounts paid or incurred by the taxpayer to certain other persons for qualified research conducted on the taxpayer's behalf (so-called contract research expenses).<sup>527</sup> Notwithstanding the limitation for contract research expenses, qualified research expenses include 100 percent of amounts paid or

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<sup>522</sup> IRC section 41(c)(5)(A).

<sup>523</sup> IRC section 41(c)(5)(B).

<sup>524</sup> IRC section 41(c)(5)(C).

<sup>525</sup> IRC section 41(c)(4).

<sup>526</sup> A special transition rule applied for fiscal-year 2006-2007 taxpayers.

<sup>527</sup> Under a special rule, 75 percent of amounts paid to a research consortium for qualified research are treated as qualified research expenses eligible for the research credit (rather than 65 percent under the general rule under IRC section 41(b)(3) governing contract research expenses) if (1) such research consortium is a tax-exempt organization that is described in IRC section 501(c)(3) (other than a private foundation) or IRC section 501(c)(6) and is organized and operated primarily to conduct scientific research, and (2) such qualified research is conducted by the consortium on behalf of the taxpayer and one or more persons not related to the taxpayer. IRC section 41(b)(3)(C).

incurred by the taxpayer to an eligible small business, university, or federal laboratory for qualified energy research.

To be eligible for the credit, the research not only has to satisfy the requirements of IRC section 174, but also must be undertaken for the purpose of discovering information that is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which constitute elements of a process of experimentation for functional aspects, performance, reliability, or quality of a business component. Research does not qualify for the credit if substantially all of the activities relate to style, taste, cosmetic, or seasonal design factors.<sup>528</sup> In addition, research does not qualify for the credit if: (1) conducted after the beginning of commercial production of the business component; (2) related to the adaptation of an existing business component to a particular customer's requirements; (3) related to the duplication of an existing business component from a physical examination of the component itself or certain other information; (4) related to certain efficiency surveys, management function or technique, market research, market testing, or market development, routine data collection or routine quality control; (5) related to software developed primarily for the taxpayer's internal use; (6) conducted outside the U.S., Puerto Rico, or any U.S. possession; (7) in the social sciences, arts, or humanities; or (8) funded by any grant, contract, or otherwise by another person (or government entity).<sup>529</sup>

#### *Research Credit Effect on Deductions*

Deductions allowed to a taxpayer under IRC section 174 (or any other section) are reduced by an amount equal to 100 percent of the taxpayer's research tax credit determined for the taxable year.<sup>530</sup> Taxpayers may alternatively elect to claim a reduced research tax credit amount under IRC section 41 in lieu of reducing deductions otherwise allowed.<sup>531</sup>

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<sup>528</sup> IRC section 41(d)(3).

<sup>529</sup> IRC section 41(d)(4).

<sup>530</sup> IRC section 280C(c). For example, assume that a taxpayer makes credit-eligible research expenditures of \$1 million during the year and that the base period amount is \$600,000. Under the standard credit calculation (*i.e.*, where a taxpayer may claim a research credit equal to 20 percent of the amount by which its qualified expenses for the year exceed its base period amount), the taxpayer is allowed a credit equal to 20 percent of the \$400,000 increase in research expenditures, or \$80,000 ( $(\$1 \text{ million} - \$600,000) \times 20\% = \$80,000$ ). To avoid a double benefit, the amount of the taxpayer's deduction under section 174 is reduced by \$80,000 (the amount of the research credit), leaving a deduction of \$920,000 ( $\$1 \text{ million} - \$80,000$ ).

<sup>531</sup> IRC section 280C(c)(3). Taxpayers making this election reduce the allowable research credit by the maximum corporate tax rate (currently 35 percent). Continuing with the example from the prior footnote, an electing taxpayer would have its credit reduced to \$52,000 ( $\$80,000 - (\$80,000 \times 0.35\%)$ ), but would retain its \$1 million deduction for research expenses. This option might be desirable for a taxpayer who cannot claim the full amount of the research credit otherwise allowable due to the limitation imposed by the alternative minimum tax.

## Specified Credits Allowed Against Alternative Minimum Tax

For any taxable year, the general business credit (which is the sum of the various business credits) generally may not exceed the excess of the taxpayer's net income tax<sup>532</sup> over the greater of (1) the taxpayer's tentative minimum tax or (2) 25 percent of so much of the taxpayer's net regular tax liability<sup>533</sup> as exceeds \$25,000.<sup>534</sup> Any general business credit in excess of this limitation may be carried back one year and forward up to 20 years.<sup>535</sup> The tentative minimum tax is an amount equal to specified rates of tax imposed on the excess of the alternative minimum taxable income over an exemption amount.<sup>536</sup> Generally, the tentative minimum tax of a C corporation with average annual gross receipts of less than \$7.5 million for prior three-year periods is zero.<sup>537</sup>

In applying the tax liability limitation to a list of "specified credits" that are part of the general business credit, the tentative minimum tax is treated as being zero.<sup>538</sup> Thus, the specified credits generally may offset both regular tax and alternative minimum tax (AMT) liabilities.

In the case of an eligible small business (as defined in IRC section 38(c)(5)(C), after application of rules similar to the rules of IRC section 38(c)(5)(D)), the research credit determined under IRC section 41 for taxable years beginning after December 31, 2015, is a specified credit. Thus, an eligible small business's research credit may offset both regular tax and AMT liabilities.<sup>539</sup>

### New Federal Law (IRC section 41)

The provision clarifies that the alternative incremental credit (expired in 2008) was not reinstated by the PATH Act, and makes conforming changes.

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<sup>532</sup> The term "net income tax" means the sum of the regular tax liability and the alternative minimum tax, reduced by the credits allowable under IRC sections 21 through 30D. IRC section 38(c)(1).

<sup>533</sup> The term "net regular tax liability" means the regular tax liability reduced by the sum of certain nonrefundable personal and other credits. IRC section 38(c)(1).

<sup>534</sup> IRC section 38(c)(1).

<sup>535</sup> IRC section 39(a)(1).

<sup>536</sup> IRC section 55(b). For example, assume a taxpayer has a regular tax of \$80,000, a tentative minimum tax of \$100,000, and a research credit determined under IRC section 41 of \$90,000 for a taxable year (and no other credits). Under present law, the taxpayer's research credit is limited to the excess of \$100,000 over the greater of (1) \$100,000 or (2) \$13,750 (25% of the excess of \$80,000 over \$25,000). Accordingly, no research credit may be claimed ( $\$100,000 - \$100,000 = \$0$ ) for the taxable year and the taxpayer's net tax liability is \$100,000. The \$90,000 research credit may be carried back or forward under the rules applicable to the general business credit.

<sup>537</sup> IRC section 55(e).

<sup>538</sup> See IRC section 38(c)(4)(B) for the list of specified credits, which does not presently include the research credit determined under IRC section 41.

<sup>539</sup> Using the above example, under this provision, the limitation would be the excess of \$80,000 over the greater of (1) \$0 or (2) \$13,750. Since \$13,750 is greater than \$0, the \$80,000 would be reduced by \$13,750 such that the research credit limitation would be \$66,250. Hence, the taxpayer would be able to claim a research credit of \$66,250 against its net income tax liability, as well as its AMT liability, which would result in \$33,250 of total tax owed ( $\$100,000 - \$66,250$ ). The remaining \$23,750 of its research credit ( $\$90,000 - \$66,250$ ) may be carried back or forward, as applicable.

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Effective Dates

The amendments made by this section are effective as if included in the provision of the PATH Act to which they relate.

California Law (R&TC sections 17052.12 and 23609)

General Rules

The PITL and the CTL generally conform to the federal research credit as of the specified date of January 1, 2015, with modifications that are generally described below. However, the California research credit is permanent. Thus, the provision to make the federal research credit permanent has no impact on California's research credit.

California modifies the general credit to be 15 percent of qualified expenses (instead of the federal rate of 20 percent of qualified expenses) and modifies the university "basic research" credit to be 24 percent of qualified expenses (instead of the federal rate of 20 percent of qualified expenses).

The terms "qualified research" and "basic research" include only research conducted in California. In computing gross receipts under IRC section 41(c)(7), only gross receipts from the sale of property held for sale in the ordinary course of business, that is delivered or shipped to a purchaser within California, are included. Qualified research expenses are modified to exclude any amount paid or incurred for tangible personal property that is eligible for the exemption from sales or use tax under R&TC section 6378.

Similar to federal law, only corporations qualify for the credit for the university "basic research" credit. However, California modifies "basic research" to include any basic or applied research including scientific inquiry or original investigation for advancement of scientific or engineering knowledge or the improved effectiveness of commercial products, with the following exceptions:

1. Basic research conducted outside California.
2. Basic research in social sciences, arts or humanities.
3. Basic research for purposes of improving a commercial product if the improvements relate to style, taste, cosmetic, or seasonal design factors.
4. Any expenditure paid or incurred to ascertain existence, location, extent, or quality of any deposit of ore or other mineral, including oil or gas.

California does not conform to the energy research credit.<sup>540</sup>

California specifically does not conform to the alternative simplified credit.<sup>541</sup> Instead, California conforms to the former federal alternative incremental credit, with modifications. The federal

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<sup>540</sup> R&TC sections 17052.12(j) and 23609(k).

<sup>541</sup> R&TC sections 17052.12(g)(4) and 23609(g)(4).

credit rates of 3 percent, 4 percent and 5 percent are modified to be 1.49 percent, 1.98 percent, and 2.48 percent, respectively.<sup>542</sup> Additionally, the federal December 31, 2008, election-termination date does not apply,<sup>543</sup> meaning taxpayers may continue to elect the alternative incremental credit regime under California law even though such an election is unavailable for federal purposes for taxable years beginning after December 31, 2008.

California generally conforms to the federal rules for eligible expenses, except for the special rules that allow qualified research expenses to include 100 percent of amounts paid or incurred by the taxpayer to an eligible small business, university, or federal laboratory for qualified energy research.

#### *Specified Credits Allowed Against Alternative Minimum Tax*

California does not conform to the general business credit, and the California research credit may not offset AMT liabilities.

#### *Payroll Tax Credit*

The FTB does not administer payroll taxes, thus there is no impact on AMT liabilities.

#### Impact on California Revenue

##### **Research Credit**

Not applicable.

##### **Specified Credits Allowed Against Alternative Minimum Tax**

Not applicable.

##### **Payroll Tax Credit**

No impact as the FTB does not administer payroll taxes.

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#### d. Bonus Depreciation (PATH Act section 143)

##### Background

##### *Bonus Depreciation under the PATH Act*

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<sup>542</sup> R&TC sections 17052.12(g) and 23609(h).

<sup>543</sup> R&TC sections 17052.12(h) and 23609(i).

## In General

Under the PATH Act, an additional first-year depreciation deduction is available generally through 2019 (through 2020 for certain longer-lived and transportation property).<sup>544</sup> The additional deduction allowed is equal to 50 percent of the adjusted basis of qualified property acquired and placed in service before January 1, 2018, (January 1, 2019, for certain longer-lived and transportation property).<sup>545</sup>

The deduction percentage is phased down from 50 percent by 10 percent per calendar year beginning in 2018 (2019 for certain longer-lived and transportation property). Thus, for qualified property (other than certain longer-lived and transportation property), the percentage for property placed in service in 2018 is 40 percent, and for 2019 is 30 percent. These same percentages apply to certain longer-lived and transportation property placed in service one year later.

The additional first-year depreciation deduction is allowed for both the regular tax and the AMT,<sup>546</sup> but is excluded in computing earnings and profits.<sup>547</sup> The basis of the property and the depreciation allowances in the year of purchase and later years are adjusted to reflect the additional first-year depreciation deduction.<sup>548</sup> The amount of the additional first-year depreciation deduction is unaffected by a short taxable year.<sup>549</sup> The taxpayer may elect out of additional first-year depreciation for any class of property for any taxable year.<sup>550</sup>

Property qualifying for the additional first-year depreciation deduction must meet all of the following requirements.<sup>551</sup> First, the property must be one or more of the following: (1) property to which MACRS applies with an applicable recovery period of 20 years or less; (2) water utility property (as defined in IRC section 168(e)(5)); (3) computer software other than computer software covered by IRC section 197; or (4) qualified leasehold improvement property.<sup>552</sup> Second,

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<sup>544</sup> Due to the passage of time since the provision's original enactment, the provision eliminates the various acquisition date requirements as no longer relevant. The provision also repeals as deadwood the provision relating to property acquired during certain pre-2012 periods (or certain pre-2013 periods for certain longer-lived and transportation property).

<sup>545</sup> IRC section 168(k). The additional first-year depreciation deduction is subject to the general rules regarding whether an item must be capitalized under IRC section 263A.

<sup>546</sup> IRC section 168(k)(2)(G). See also Treas. Reg. section 1.168(k)-1(d).

<sup>547</sup> Treas. Reg. section 1.168(k)-1(f)(7).

<sup>548</sup> IRC section 168(k)(1)(B).

<sup>549</sup> *Ibid.*

<sup>550</sup> IRC section 168(k)(2)(D)(iii). For the definition of a class of property, see Treas. Reg. section 1.168(k)-1(e)(2).

<sup>551</sup> Requirements relating to actions taken before 2008 are not described herein since they have little (if any) remaining effect.

<sup>552</sup> The additional first-year depreciation deduction is not available for any property that is required to be depreciated under the alternative depreciation system of MACRS. IRC section 168(k)(2)(D)(i).



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the original use<sup>553</sup> of the property must commence with the taxpayer.<sup>554</sup> 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. 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 and certain transportation property.<sup>555</sup>

To qualify, property must be acquired (1) before January 1, 2020, or (2) pursuant to a binding written contract entered into before January 1, 2020. With respect to property that is manufactured, constructed, or produced by the taxpayer for use by the taxpayer, the taxpayer must begin the manufacture, construction, or production of the property before January 1, 2020.<sup>556</sup> 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.<sup>557</sup> 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.<sup>558</sup> The limitation under IRC section 280F on the amount of depreciation deductions allowed with respect to certain passenger automobiles placed in service before 2018 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).<sup>559</sup> While the underlying IRC section 280F limitation is indexed for inflation,<sup>560</sup> the additional \$8,000 amount is not indexed for inflation. For automobiles placed in service during 2018 the amount is \$6,400, and for automobiles placed in service during 2019 the amount is \$4,800.

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<sup>553</sup> The term “original use” means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. If in the normal course of its business a taxpayer sells fractional interests in property to unrelated third parties, then the original use of such property begins with the first user of each fractional interest (*i.e.*, each fractional owner is considered the original user of its proportionate share of the property). Treas. Reg. section 1.168(k)-1(b)(3).

<sup>554</sup> A special rule applies in the case of certain leased property. In the case of any property that is originally placed in service by a person and that is sold to the taxpayer and leased back to such person by the taxpayer within three months after the date that the property was placed in service, the property would be treated as originally placed in service by the taxpayer not earlier than the date that the property is used under the leaseback. If property is originally placed in service by a lessor, 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).

<sup>555</sup> Property qualifying for the extended placed-in-service date must have an estimated production period exceeding one year and a cost exceeding \$1 million. 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.

<sup>556</sup> IRC section 168(k)(2)(E)(i).

<sup>557</sup> Treas. Reg. section 1.168(k)-1(b)(4)(iii).

<sup>558</sup> IRC section 168(k)(2)(B)(ii). For purposes of determining the amount of eligible progress expenditures, rules similar to IRC section 46(d)(3) as in effect prior to the Tax Reform Act of 1986 apply.

<sup>559</sup> IRC section 168(k)(2)(F).

<sup>560</sup> See IRC section 280F(d)(7).



## 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.<sup>561</sup> The improvement must be made under or pursuant to a lease either by the lessee (or sublessee), or by the lessor, of that portion of the building to be occupied exclusively by the lessee (or sublessee). 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. For these purposes, a binding commitment to enter into a lease is treated as a lease, and the parties to the commitment are treated as lessor and lessee. A lease between related persons is not considered a lease for this purpose.

## Special Rule 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.<sup>562</sup> 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 certain longer-lived and transportation property).

## Election to Accelerate AMT Credits in Lieu of Bonus Depreciation

An election to increase the AMT credit limitation in lieu of bonus depreciation can be made for property placed in service before January 1, 2020, (January 1, 2021, in the case of certain longer-lived property and transportation property).

For taxable years ending after December 31, 2014, and before January 1, 2016, a bonus depreciation amount, maximum amount, and maximum increase amount is computed separately with respect to property to which the extension of additional first-year depreciation applies (“round-5 extension property”).<sup>563</sup> A separate bonus depreciation amount, maximum amount, and maximum increase amount is computed and applied to round-5 extension property.<sup>564</sup> A corporation that has an election in effect with respect to round-4 extension property claiming minimum tax credits in lieu of bonus depreciation is treated as having an election in effect for round-5 extension property, unless the corporation elects otherwise. The provision also allows a corporation that does not have an election in effect with respect to round-4 extension property to elect to claim minimum tax credits in lieu of bonus depreciation for round-5 extension property.

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<sup>561</sup> IRC section 168(k)(3). The additional first-year depreciation deduction is not available for qualified New York Liberty Zone leasehold improvement property as defined in IRC section 1400L(c)(2). IRC section 168(k)(2)(D)(ii).

<sup>562</sup> See IRC section 460.

<sup>563</sup> An election with respect to round 5 extension property is binding for all property that is eligible qualified property solely by reason of the extension of the 50-percent additional first-year depreciation deduction.

<sup>564</sup> In computing the maximum amount, the maximum increase amount for round-5 extension property is reduced by bonus depreciation amounts for preceding taxable years only with respect to round-5 extension property.

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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).

The provision also requires that 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 must take into account its distributive share of partnership depreciation in determining its bonus depreciation amount.

### **Special Rules for Certain Fruit and Nut Bearing Plants**

An election is available for certain plants, living plants, bearing fruits and nuts. 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.<sup>565</sup> The percentage is 50 percent for 2016, and then is phased down by 10 percent per calendar year beginning in 2018. Thus, the percentage for 2018 is 40 percent, and for 2019 is 30 percent. 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.<sup>566</sup> 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.

*Bonus Depreciation under the TCJA*<sup>567</sup>

### **In General**

The TCJA 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 TCJA 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

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<sup>565</sup> Any amount deducted under this election is not subject to capitalization under IRC section 263A.

<sup>566</sup> A specified plant does not include any property that is planted or grafted outside of the U.S.

<sup>567</sup> Public Law 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, commonly referred to as the Tax Cuts and Jobs Act (TCJA), enacted December 22, 2017.

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(after 2023 for longer production period property and certain aircraft). Under the TCJA, the bonus depreciation percentage rates are as follows:

Placed in Service Year <sup>568</sup>	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 <sup>569</sup>

### Application to Used Property

The TCJA removed the requirement that the original use of qualified property must commence with the taxpayer. Thus, the TCJA applied to purchases of used as well as new items. To prevent abuses, the additional first-year depreciation deduction applied only to property purchased in an arm's-length transaction. It does not apply to property received as a gift or from a decedent.<sup>570</sup> In the case of trade-ins, like-kind exchanges, or involuntary conversions, it applied only to money paid in addition to the traded-in property or in excess of the adjusted basis of the replaced property.<sup>571</sup> It did not apply to property (1) acquired in a nontaxable exchange such as a reorganization, (2) acquired from a member of the taxpayer's family, including a spouse, ancestor, or lineal descendant, or from another related entity as defined in IRC section 267, or (3) acquired from a person who controls, is controlled by, or is under common control with, the taxpayer.<sup>572</sup> Thus, it does not apply, for example, if one member of an affiliated group of corporations purchased property from another member, or if an individual who controlled a corporation purchased property from that corporation.

### Special Rules

The TCJA maintains the IRC section 280F changes applicable for passenger automobiles placed in service after December 31, 2017.

The TCJA 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).

<sup>568</sup> In the case of specified plants, this is the year of planting or grafting.

<sup>569</sup> 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.

<sup>570</sup> By reference to IRC section 179(d)(2)(C). See also Treas. Reg. section 1.179-4(c)(1)(iv).

<sup>571</sup> By reference to IRC section 179(d)(3). See also Treas. Reg. section 1.179-4(d).

<sup>572</sup> By reference to IRC section 179(d)(2)(A) and (B).

See also Treas. Reg. section 1.179-4(c).

## **Application to Qualified Film, Television and Live Theatrical Productions**

The TCJA expands the definition of qualified property eligible for the additional first-year depreciation allowance to include qualified film, television and live theatrical productions<sup>573</sup> 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 of the TCJA, 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).

## **Exception for Certain Businesses Not Subject to Limitation on Interest Expense**

The TCJA excludes from the definition of qualified property any property 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 applicable, have been established or approved by a state or political subdivision thereof, by any agency or instrumentality of the U.S., 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 TCJA 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 TCJA, in the case of property acquired or property with an adjusted basis incurred before September 28, 2017, the bonus depreciation rates are as follows:

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<sup>573</sup> As defined in section 181(d) and (e).

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 TCJA repeals the election to accelerate AMT credits in lieu of bonus depreciation.

New Federal Law (IRC section 168)

The provision corrects an unintended error that changed prior law. It clarifies that, among the criteria in the PATH Act defining certain property having a longer production period that is treated as qualified property, the requirement that the property be acquired pursuant to a written *contract* before 2020 requires that the contract be a written contract, binding on all applicable parties to the contract.

The provision clarifies that the preproductive period under IRC section 168(k)(5)(B)(ii) is consistent with the preproductive period under IRC section 263A(e)(3). In addition, the provision amends IRC section 168(k)(6), as in effect prior to the amendments made by section 13201 of the 2017 TCJA,<sup>574</sup> to provide the intended applicable percentages. Thus, the provision clarifies that in the case of longer production period property and certain aircraft acquired before September 28, 2017, and placed in service in 2018, 50 percent applies to the entire adjusted basis, and if placed in service in 2019, 40 percent applies to the entire adjusted basis.

The provision corrects an unintended error that changed prior law. It clarifies that if, for a taxable year, a taxpayer makes both an election under IRC section 168(k)(7) not to claim bonus depreciation for all property in a particular class of property and an election under IRC section 168(k)(4) to claim AMT credits in lieu of bonus depreciation, IRC section 168(k)(4) does not apply to the property in the particular class.

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<sup>574</sup> Pub. L. No. 115-97, enacted December 22, 2017.

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Effective Dates

The amendments made by this section are effective as if included in the provision of the PATH Act to which they relate.

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

This provision is inapplicable under California law.

The PITL generally conforms to MACRS as of the specified date of January 1, 2015,<sup>575</sup> but specifically does not conform to bonus depreciation.<sup>576</sup>

The CTL does not adopt MACRS, and instead is generally in substantial conformity to the pre-1981 federal Asset Depreciation Rules (ADR) rules that generally allow property to be depreciated based on its “useful life.”<sup>577</sup>

Impact on California Revenue

Not applicable.

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e. Election Out of Accelerated Recovery Periods for Qualified Indian Reservation Property (PATH Act section 167)

Background

With respect to certain property used in connection with the conduct of a trade or business within an Indian reservation, depreciation deductions under IRC section 168(j) are determined using the following recovery periods:

3-year property .....	2 years
5-year property .....	3 years
7-year property .....	4 years
10-year property .....	6 years
15-year property .....	9 years
20-year property .....	12 years
Nonresidential real property .....	22 years <sup>578</sup>

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<sup>575</sup> R&TC section 17201 conforms to MACRS under IRC section 168 as of the specified date of January 1, 2015, with modifications.

<sup>576</sup> R&TC section 17250(a)(2)(C)(4).

<sup>577</sup> R&TC section 24349.

<sup>578</sup> IRC section 168(j)(2) does not provide shorter recovery periods for water utility property, residential rental property, or railroad grading and tunnel bores.

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“Qualified Indian reservation property” eligible for accelerated depreciation includes property described in the table above that is: (1) used by the taxpayer predominantly in the active conduct of a trade or business within an Indian reservation; (2) not used or located outside the reservation on a regular basis; (3) not acquired (directly or indirectly) by the taxpayer from a person who is related to the taxpayer;<sup>579</sup> and (4) is not property placed in service for purposes of conducting gaming activities.<sup>580</sup> Certain “qualified infrastructure property” may be eligible for the accelerated depreciation even if located outside an Indian reservation, provided that the purpose of such property is to connect with qualified infrastructure property located within the reservation (e.g., roads, power lines, water systems, railroad spurs, and communications facilities).<sup>581</sup>

An “Indian reservation” means a reservation as defined in section 3(d) of the Indian Financing Act of 1974 (25 U.S.C. 1452(d))<sup>582</sup> or section 4(10) of the Indian Child Welfare Act of 1978 (25 U.S.C. 1903(10)).<sup>583</sup> For purposes of the preceding sentence, section 3(d) is applied by treating “former Indian reservations in Oklahoma” as including only lands that are (1) within the jurisdictional area of an Oklahoma Indian tribe as determined by the Secretary of the Interior, and (2) recognized by such Secretary as an area eligible for trust land status under 25 C.F.R. Part 151 (as in effect on August 5, 1997).<sup>584</sup>

The depreciation deduction allowed for regular tax purposes is also allowed for purposes of the AMT.<sup>585</sup> The accelerated depreciation for qualified Indian reservation property is available with respect to property placed in service on or before December 31, 2016.<sup>586</sup>

In addition, a taxpayer may annually make an irrevocable election out of IRC section 168(j) on a class-by-class basis for qualified Indian reservation property placed in service in taxable years beginning after December 31, 2015. The PATH Act amended IRC section 168(j) to permit taxpayers to elect out of the otherwise applicable accelerated recovery periods in the case of qualified Indian reservation property. In general, if IRC section 168(j) applies, there is no AMT adjustment (see IRC section 168(j)(3)).

#### New Federal Law (IRC section 168)

The provision clarifies that no AMT adjustment applies in the case of qualified Indian reservation property if the taxpayer makes the IRC section 168(j)(3) election.

#### Effective Dates

The amendments made by this section are effective as if included in the provision of the PATH Act to which they relate.

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<sup>579</sup> For these purposes, the term “related persons” is defined in IRC section 465(b)(3)(C).

<sup>580</sup> IRC section 168(j)(4)(A).

<sup>581</sup> IRC section 168(j)(4)(C).

<sup>582</sup> Public Law 93-262.

<sup>583</sup> Public Law 95-608.

<sup>584</sup> IRC section 168(j)(6).

<sup>585</sup> IRC section 168(j)(3).

<sup>586</sup> IRC section 168(j)(8).



California Law (R&TC sections 17250 and 24349-24355.4)

This provision is inapplicable under California law.

The PITL generally conforms to MACRS, but specifically does not conform to accelerated depreciation for business property on an Indian reservation.<sup>587</sup>

The CTL does not adopt MACRS. The CTL is generally in substantial conformity to the pre-1981 federal ADR rules, which generally allow property to be depreciated based on its “useful life.”<sup>588</sup>

Impact on California Revenue

Not applicable.

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f. Failure to Furnish Correct Payee Statements (PATH Act section 202)

Background

**In General**

Failure to comply with information reporting requirements generally results in penalties, which may include a penalty for failure to file the information return,<sup>589</sup> failure to furnish payee statements,<sup>590</sup> or failure to comply with other various reporting requirements.<sup>591</sup> No penalty is imposed if the failure is due to reasonable cause.<sup>592</sup>

Any person who is required to file an information return statement, or furnish a payee statement, but who fails to do so on or before the prescribed due date, is subject to a penalty that varies based on when, if at all, the information return is filed. Both the failure to file and failure to furnish penalties are adjusted annually to account for inflation.

**Penalties with Respect to Returns or Statements—Due Before January 1, 2016**

If a person files an information return after the prescribed filing date but on or before the date that is 30 days after the prescribed filing date, the amount of the penalty is \$30 per return (“first-tier penalty”), with a maximum penalty of \$250,000 per calendar year. If a person files an information return after the date that is 30 days after the prescribed filing date but on or before August 1, of the same year, the amount of the penalty is \$60 per return (“second-tier penalty”),

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<sup>587</sup> R&TC section 17250(a)(3).

<sup>588</sup> R&TC sections 24349-24355.4.

<sup>589</sup> IRC section 6721.

<sup>590</sup> IRC section 6722.

<sup>591</sup> IRC section 6723. The penalty for failure to comply timely with a specified information reporting requirement is \$50 per failure, not to exceed \$100,000 per calendar year.

<sup>592</sup> IRC section 6724.

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with a maximum penalty of \$500,000 per calendar year. If an information return is not filed on or before August 1 of any year, the amount of the penalty is \$100 per return (“third-tier penalty”), with a maximum penalty of \$1,500,000 per calendar year. If a failure to file is due to intentional disregard of a filing requirement, the minimum penalty for each failure is \$250, with no calendar year limit.

Lower maximum levels for the failure to file correct information return penalty apply to small businesses. Small businesses are defined as firms having average annual gross receipts for the most recent three taxable years that do not exceed \$5 million. The maximum penalties for small businesses are: \$75,000 (instead of \$250,000) if the failures are corrected on or before 30 days after the prescribed filing date; \$200,000 (instead of \$500,000) if the failures are corrected on or before August 1; and \$500,000 (instead of \$1,500,000) if the failures are not corrected on or before August 1.

Any person who is required to furnish a payee statement 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 payee statement is furnished, similar to the penalty for filing an information return discussed above. A first-tier penalty is \$30, subject to a maximum of \$250,000, a second-tier penalty is \$60 per statement, up to \$500,000, and a third-tier penalty is \$100, up to a maximum of \$1,500,000.

Lower maximum levels for the failure to furnish correct payee statement penalty apply to small businesses. Small businesses are defined as firms having average annual gross receipts for the most recent three taxable years that do not exceed \$5 million. The maximum penalties for small businesses are: \$75,000 (instead of \$250,000) if the failures are corrected on or before 30 days after the prescribed filing date; \$200,000 (instead of \$500,000) if the failures are corrected on or before August 1; and \$500,000 (instead of \$1,500,000) if the failures are not corrected on or before August 1.

In cases in which the failure to file an information return or to furnish the correct payee statement is due to intentional disregard, the minimum penalty for each failure is \$250, with no calendar-year limit, and no distinction is made between small businesses and other persons required to report.

#### **Penalties with Respect to Returns or Statements—Due After December 31, 2015**

The Trade Preferences Extension Act of 2015 increased the penalties to the following amounts for information returns or payee statements due after December 31, 2015. The first-tier penalty is \$50 per return, with a maximum penalty of \$500,000 per calendar year. The second-tier penalty increases to \$100 per return, with a maximum penalty of \$1,500,000 per calendar year. The third-tier penalty increases to \$250 per return, with a maximum penalty of \$3,000,000 per calendar year.

The lower maximum levels applicable to small businesses also were increased, as follows. The maximum penalties for small businesses are: \$175,000 if the failures are corrected on or before 30 days after the prescribed filing date; \$500,000 if the failures are corrected on or before August 1; and \$1,000,000 if the failures are not corrected on or before August 1.

For failures or misstatements due to intentional disregard, the penalty per return or statement increased to \$500, with no calendar-year limit, and no distinction between small businesses and other persons required to report is made in such cases.

### **Safe Harbor Provision for Returns or Statements—Due After December 31, 2016**

A safe harbor provision precludes the application of the penalty for failure to file a correct information return and the penalty for failure to furnish a correct payee statement in circumstances in which the information return or payee statement is otherwise correctly filed but includes a *de minimis* error of the amount required to be reported on such return or statement. In general, a *de minimis* error of an amount on the information return or statement need not be corrected if the error for any single amount does not exceed \$100. A lower threshold of \$25 is established for errors with respect to the reporting of an amount of withholding or backup withholding. The provision requires broker reporting to be consistent with amounts reported on uncorrected returns which are eligible for the safe harbor. If any person receiving payee statements requests a corrected statement, the penalty for failure to file a correct information return and the penalty for failure to furnish a correct payee statement would continue to apply in the case of a *de minimis* error.

#### New Federal Law (IRC sections 6721 and 6722)

The provision clarifies IRC section 6722(c)(3)(A), relating to failure to furnish correct payee statements, to refer to the payee statement (rather than to information returns) that are furnished (rather than filed). A corresponding change in the effective date stated in the PATH Act refers to statements that are furnished (rather than provided). Similarly-structured language in IRC section 6721(c)(3)(A) is conformed so that it refers to the information return (rather than to any information return).

#### Effective Dates

The amendments made by this section are effective as if included in the provision of the PATH Act to which they relate.

#### California Law (R&TC section 19183)

California conforms with modifications, to IRC sections 6721 and 6722 as of the specified date of January 1, 2015. California does not conform to this provision's *de minimis* safe harbors, e.g., penalty increases applicable to information returns and payee statements due after December 31, 2015, and provision clarifications. Thus, there is no need to conform to the modifications as California does not conform to the underlying provisions.

California conforms to the penalty amounts described above that applied to returns or statements due before January 1, 2016, modified to provide that the California penalties are adjusted to account for inflation every five years.<sup>593</sup>

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<sup>593</sup> R&TC section 19183(a)(3) and (b)(3).

Impact on California Revenue

Not applicable.

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g. Requirements for the Issuance of Individual Taxpayer Identification Numbers (ITINs) (PATH Act section 203)

Background

Any individual filing a U.S. tax return is required to state his or her taxpayer identification number on such return. Generally, a taxpayer identification number is the individual's Social Security number (SSN).<sup>594</sup> However, in the case of individuals who are ineligible for an SSN, and have a tax filing obligation, the IRS issues IRS ITINs for use in connection with the individual's tax filing requirements.<sup>595</sup> An individual who is eligible to receive an SSN may not obtain an ITIN for purposes of his or her tax filing obligations.<sup>596</sup> An ITIN does not provide eligibility to (1) work in the U.S. or (2) claim Social Security benefits.

Examples of individuals who may need an ITIN in order to file a U.S. return include a:

- 1) Nonresident alien filing a claim for a reduced withholding rate under treaty benefits,
- 2) Nonresident alien required to file a U.S. tax return,
- 3) U.S. resident alien filing a U.S. tax return,
- 4) Dependent or spouse of a U.S. citizen or resident alien, or
- 5) Dependent or spouse of a nonresident alien visa holder.

**ITIN Application Procedures**

Individuals applying for an ITIN must complete a Form W-7, "Application for IRS Individual Taxpayer Identification Number." The IRS is authorized to issue ITINs to individuals either in-person or via mail. In-person applications may be submitted to either: (1) an employee of the IRS or (2) a community-based certified acceptance agent approved by the Secretary.<sup>597</sup> In the case of individuals residing outside of the U.S., in-person applications may be submitted to an employee of the IRS or a designee of the Secretary at a U.S. diplomatic mission or consular post. The provision authorizes the IRS to establish procedures to accept ITIN applications via mail.

The IRS maintains a program for certifying and training community-based acceptance agents. Persons eligible to be acceptance agents may include financial institutions, colleges and

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<sup>594</sup> IRC section 6109(a).

<sup>595</sup> Treas. Reg. section 301.6109-1(d)(3)(i).

<sup>596</sup> Treas. Reg. section 301.6109-1(d)(3)(ii).

<sup>597</sup> The community-based certified acceptance agent program is intended to expand the existing IRS acceptance agent program. See Revenue Procedure 2006-10, 2006-1 C.B. 293 (December 16, 2005).

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universities, federal agencies, state and local governments, including state agencies responsible for vital records, persons that provide assistance to taxpayers in the preparation of their tax returns, and other persons or categories of persons as authorized by regulations or in other guidance issued by the IRS.

The IRS determines what documents are acceptable for purposes of proving an individual's identity, foreign status and residency. However, only original documents or certified copies meeting the requirements set forth by the IRS are acceptable. Additionally, the provision requires the IRS to develop procedures that distinguish ITINs used by individuals solely for the purpose of obtaining treaty benefits, so as to ensure that such numbers are used only for that reason.

### Term of ITINs

#### *General Rule*

Any ITIN issued after December 31, 2012, expires if not used on a federal income tax return for a period of three consecutive taxable years (expiring on December 31 of such third consecutive year). The IRS is provided with math-error authority related to returns filed with an ITIN that has expired, been revoked by the Secretary, or that is otherwise invalid.

#### *Special Rule in the Case of ITINs Issued Prior to 2013*

ITINs issued prior to 2013, while remaining subject to the general rule described above,<sup>598</sup> will, regardless of whether such ITIN has been used on federal income tax returns, no longer be valid as of the applicable date, as follows:

Year ITIN Issued	Applicable Date
Pre-2008	January 1, 2017
2008	January 1, 2018
2009 or 2010	January 1, 2019
2011 or 2012	January 1, 2020

The Treasury Office of Inspector General must conduct an audit of the ITIN application process two years after December 18, 2015, and every two years thereafter.

#### New Federal Law (IRC sections 6109)

The provision clarifies that community-based Certifying Acceptance Agents are among the entities that are available to individuals living abroad who wish to obtain ITINs for purposes of meeting their U.S. tax filing obligations.

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<sup>598</sup> In the case of ITINs that, including taxable year 2015, have been unused on federal income tax returns for three (or more) consecutive taxable years, such ITINs expire on December 31, 2015.

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The provision clarifies that the expiration of ITINs that are unused for three consecutive taxable years occurs on the date following the due date of the tax return for such third consecutive taxable year. For ITINs issued prior to January 1, 2013, the ITIN will expire on the applicable date, or if earlier, the day following the due date of the tax return for the third consecutive taxable year such ITIN was not used on a return. In the event that such an ITIN has not been used for three (or more) consecutive taxable years on the tax return due date for the 2015 taxable year, such ITIN shall expire on the day following that date.

The provision clarifies that the effective date of the PATH Act section 203 for ITIN applications made after the date of enactment, does not prevent the provision from taking effect.

### Effective Dates

The amendments made by this section are effective as if included in the provision of the PATH Act to which they relate.

### California Law (R&TC section 18624)

California conforms to IRC section 6109 as of the specified date of January 1, 2015,<sup>599</sup> with modifications. Thus, California does not conform to this provision's clarifications relating to obtaining ITINs by individuals living abroad for purposes of meeting their tax obligations. Regardless, California would recognize a valid ITIN.

### Impact on California Revenue

Not applicable.

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h, i, and j. Retroactive Claims of Credits (PATH Act sections 204, 205, and 206)

### Background

#### **Refundable Credits**

An individual may reduce his or her tax liability by available tax credits. The IRC allows certain credits against the income tax.<sup>600</sup> Most of the credits may not exceed the taxpayer's income tax. However certain credits ("refundable credits") may exceed the tax and the amount of these credits in excess of the tax imposed (reduced by the other credits) is an overpayment which creates a

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<sup>599</sup> R&TC section 17024.5.

<sup>600</sup> IRC sections 21-54AA.

refund or credit.<sup>601</sup> Refundable credits include three significant refundable credits, the Child Tax Credit (CTC), the EITC, and the American opportunity tax credit (AOTC).<sup>602</sup>

For taxable years beginning after December 31, 2017, and before January 1, 2026, the CTC is \$2,000 per qualifying child. In addition, a \$500 nonrefundable credit is available for qualifying dependents other than qualifying children. The maximum amount of the CTC that is refundable may not exceed \$1,400 per qualifying child.<sup>603</sup> Additionally, in order to receive the CTC (*i.e.*, both the refundable and non-refundable portion), a taxpayer must include a SSN for each qualifying child for whom the credit is claimed on the tax return. For these purposes, a SSN 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.<sup>604</sup>

A qualifying child is an individual who has not attained age 17 during the taxable year.

The CTC begins to phase out for taxpayers with AGI in excess of \$400,000 (in the case of married taxpayers filing a joint return) and \$200,000 (for all other taxpayers). The phase-out thresholds are not indexed for inflation.

The EITC is available to low-income workers who satisfy certain requirements. The amount of the EITC varies depending upon the taxpayer's earned income and whether the taxpayer has one, two, more than two, or no qualifying children. In 2018, the maximum EITC is \$6,431 for taxpayers with more than two qualifying children, \$5,716 for taxpayers with two qualifying children, \$3,461 for taxpayers with one qualifying child, and \$519 for taxpayers with no qualifying children. The credit amount begins to phase out at an income level of \$24,350 for joint-filers with children, \$18,660 for other taxpayers with children, \$14,170 for joint-filers with no children and \$8,490 for other taxpayers with no qualifying children. The phase-out percentages are 15.98 for taxpayers with one qualifying child, 21.06 for two or more qualifying children and 7.65 for no qualifying children.

The AOTC is a credit for qualified education expenses paid for an eligible student for the first four years of higher education. The maximum annual credit is \$2,500 per eligible student. If the credit brings the amount of tax to zero, 40 percent of any remaining amount of the credit (up to \$1,000) is refundable.

The amount of the credit is 100 percent of the first \$2,000 of qualified education expenses paid for each eligible student and 25 percent of the next \$2,000 of qualified education expenses paid for that student.

### Identification Requirements with Respect to Refundable Credits

In order to claim the EITC, a taxpayer must include his or her taxpayer identification number (and if the taxpayer is married filing a joint return, the taxpayer identification number of the taxpayer's

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<sup>601</sup> IRC section 6401(b).

<sup>602</sup> Refundable credits include credits for withholding of taxes. Treas. Reg. sections 1-6664-2(b) and (c) provide special rules for the withholding credits.

<sup>603</sup> The provision uses an indexing convention that rounds the \$1,400 amount to the next lowest multiple of \$100.

<sup>604</sup> Additionally, a qualifying child who is ineligible to receive the CTC because that child did not have a SSN as the child's taxpayer identification number may nonetheless qualify for the non-refundable \$500 credit.



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spouse) on the tax return.<sup>605</sup> For these purposes, a taxpayer identification number must be a SSN issued by the Social Security Administration.<sup>606</sup> Similarly, the taxpayer identification number for any child claimed by a taxpayer for purposes of determining the EITC must be included on the tax return,<sup>607</sup> and must be an SSN issued by the Social Security Administration.<sup>608</sup>

The CTC may not be claimed with respect to any qualifying child unless the taxpayer includes the name and taxpayer identification number of such qualifying child on the tax return for the taxable year.<sup>609</sup> The taxpayer identification number for the CTC is not limited to an SSN, as is the case for the EITC. Thus, a taxpayer may claim a child using either a SSN or an ITIN, issued by the IRS, for the qualifying child.

Additionally, a child may be identified on the return using an adoption taxpayer identification number (ATIN). There are no specific rules regarding the identifying number affiliated with the taxpayer claiming the CTC or EITC. Thus, the general rules applicable to all taxpayers, requiring that an identifying number accompany the return, are applicable.<sup>610</sup>

For the AOTC (in addition to the other credits with respect to amounts paid for educational expenses), no credit may be claimed by a taxpayer with respect to the qualifying tuition and related expenses of an individual, unless that individual's taxpayer identification number is included on the tax return.<sup>611</sup> As with the CTC, a taxpayer identification number for purposes of the AOTC is not limited to an SSN. Thus, a taxpayer may claim the credit with the use of an ITIN (either the taxpayer's own ITIN, if they are filing as a non-dependent and claiming tuition expenses incurred on their own behalf, or the ITIN or ATIN of a dependent to whom the credit relates).

The CTC, EITC, and AOTC, are denied with respect to any taxable year for which such taxpayer, a qualifying child (in the case of the EITC and CTC), or a student (in the case of the AOTC) has a taxpayer identification number that has been issued after the due date for filing the return for such taxable year.

### New Federal Law (IRC section 24)

The provision corrects a reference within IRC section 24(e)(2) to the "identifying number" and removes special effective date rules that had no practical effect.

### Effective Dates

The amendments made by this section are effective as if included in the provision of the PATH Act to which they relate.

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<sup>605</sup> IRC section 32(c)(1)(E)(i) and (ii).

<sup>606</sup> IRC section 32(m).

<sup>607</sup> IRC section 32(c)(3)(D).

<sup>608</sup> IRC section 32(m).

<sup>609</sup> IRC section 24(e).

<sup>610</sup> IRC section 6109.

<sup>611</sup> IRC section 25A(g)(1).

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California Law (R&TC section 17052)

California law provides a refundable California EITC that is generally determined in accordance with IRC section 32, as applicable for federal income tax purposes for the taxable year,<sup>612</sup> except as modified.<sup>613</sup>

California conforms to the federal definitions of an “eligible individual” and a “qualifying child” with the following exceptions:

- An eligible individual without a qualifying child must have a principal place of abode in “this state” (rather than the U.S.) for more than one-half of the taxable year.
- A qualifying child also must have a principal place of abode in “this state” (rather than the U.S.) for more than one-half of the taxable year.

California conforms to the federal requirement that an eligible individual and any qualifying child must have a valid SSN.

For purposes of the California EITC, the federal definition of “earned income” is modified to include wages, salaries, tips, and other employee compensation, includable in federal AGI, but only if such amounts are subject to California withholding.<sup>614</sup> For taxable years beginning on or after January 1, 2015, and before January 1, 2017, earned income specifically excluded net earnings from self-employment.

For taxable years beginning on or after January 1, 2017, the California EITC was modified to include, in the definition of earned income, net earnings from self-employment, consistent with federal law, and to increase the maximum AGI amounts at which the California EITC is completely phased-out.

For 2017, the California EITC is generally available to households with AGI of less than \$22,323.

For taxable years beginning on or after January 1, 2018, the age limit for an eligible individual without a qualifying child is 18 years or older, rather than between the ages of 25 and 64 years.<sup>615</sup>

Additionally, California law provides that for taxable years beginning on or after January 1, 2018, and before January 1, 2019, the percentage change in the California Consumer Price Index (CCPI) is the greater of 3.1 percent or the percentage change in the CCPI as calculated under R&TC section 17041(h) for that taxable year.

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<sup>612</sup> Regardless of the specified date of January 1, 2015 under R&TC section 17024.5.

<sup>613</sup> R&TC section 17052. The California EITC is only operative for taxable years the annual Budget Act specifies an adjustment factor and authorizes resources for the FTB to oversee and audit returns associated with the California EITC. Refunds for the California EITC are paid from the continuously appropriated Tax Relief and Refund Account.

<sup>614</sup> Pursuant to Division 6 (commencing with section 13000) of the Unemployment Insurance Code.

<sup>615</sup> The eligible individual must not have attained age 65 before the close of the taxable year.

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For the 2018 taxable year, the California EITC percentages and phase-out amounts are:

An Eligible Individual with:	The Credit Percentage is:	The Phase-Out Percentage is:
No Qualifying Children	7.65%	7.65%
1 Qualifying Child	34%	34%
2 Qualifying Children	40%	40%
3 or More Qualifying Children	45%	45%

For the 2018 taxable year, if the credit amount calculated under the above table is less than \$103 for no qualifying children or less than \$258 for one or more qualifying children, the California EITC percentages and phase-out amounts are:

An Eligible Individual with:	The Credit Percentage is:	The Phase-Out Percentage is:
No Qualifying Children	2.20%	1.08%
1 Qualifying Child	3.10%	2.00%
2 Qualifying Children	2.13%	2.82%
3 or More Qualifying Children	2.12%	2.85%

The 2018 earned income, phase-out and maximum credit amounts are shown below (these amounts are indexed annually for inflation):

An Eligible Individual with:	Earned Income Amount (Maximum Credit Fully Phased-in)	Completely Phased-Out at:	2015 Maximum Credit (Before EITC Adjustment Factor)	2015 Maximum Credit (With 85% EITC Adjustment Factor)
No Qualifying Children	\$3,580	\$16,750	\$273	\$232
1 Qualifying Child	\$5,376	\$24,950	\$1,828	\$1,554
2 Qualifying Children	\$7,547	\$24,950	\$3,011	\$2,559
3 or More Qualifying Children	\$7,547	\$24,950	\$3,387	\$2,879

## Impact on California Revenue

Baseline.

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### k. Effective Date for Treatment of Credits for Certain Penalties (PATH Act section 209)

#### Background

##### **Underpayment Penalties**

Under present law, an accuracy-related penalty or a fraud penalty may be imposed on certain underpayments of tax.<sup>616</sup> The IRC imposes a 20-percent penalty on the portion of an underpayment attributable to: negligence or disregard of rules or regulations, a substantial understatement, a substantial valuation overstatement, a substantial overstatement of pension liabilities, a substantial estate or gift tax valuation understatement, any disallowance of tax benefits by reason of lacking economic substance, or any undisclosed foreign financial asset understatement.<sup>617</sup> A penalty of 75 percent of an underpayment is imposed in the case of fraud. An exception to these penalties for reasonable cause generally applies.<sup>618</sup> An underpayment, for this purpose, means the excess of the amount of tax imposed over the amount of tax shown on the return.<sup>619</sup>

These penalties are assessed in the same manner as taxes.<sup>620</sup> In the case of income taxes, a taxpayer may contest any deficiency in tax determined by the IRS in the Tax Court before an assessment of the tax may be made.<sup>621</sup> Generally a deficiency in tax is the excess of the amount of tax imposed over the amount of tax shown on the return.<sup>622</sup>

The definition of underpayment applicable to the determination of accuracy-related and fraud penalties incorporates the rule that in determining the tax imposed and the amount of tax shown on the return, the excess of refundable credits (*i.e.*, the refundable portion of the CTC, the EITC, and the AOTC) over the tax is taken into account as negative amount of tax. Thus, if a taxpayer

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<sup>616</sup> IRC sections 6662 and 6663. Present law also imposes a separate accuracy-related 20-percent penalty on portions of an underpayment attributable to a listed or reportable transaction. IRC section 6662A(a). The penalty increases to 30 percent if the transaction is not adequately disclosed. IRC sections 6662A(c) and 6664(d)(2)(A).

<sup>617</sup> The 20-percent penalty is increased to 40 percent when there is a gross valuation misstatement involving a substantial valuation overstatement, a substantial overstatement of pension liabilities, a substantial estate or gift tax valuation understatement, or when a transaction lacking economic substance is not properly disclosed. IRC section 6662(h) and 6662(i).

<sup>618</sup> IRC section 6664(c). There is no reasonable cause exception for tax benefits disallowed by reason of a transaction lacking economic substance and certain valuation overstatements related to charitable deduction property.

<sup>619</sup> IRC section 6664(a). Previous assessments and rebates may also be taken into account.

<sup>620</sup> IRC section 6665(a).

<sup>621</sup> IRC section 6211-6215.

<sup>622</sup> IRC section 6211. Previous assessments and rebates may also be taken into account.

files an income tax return erroneously claiming refundable credits in excess of tax, there is an underpayment on which a penalty may be imposed.

### **Erroneous Claims**

Present law imposes a penalty of 20 percent on the amount by which a claim for refund or credit exceeds the amount allowable unless it is shown that the claim has reasonable cause.<sup>623</sup> The penalty does not apply to claims relating to the EITC, or to the portion of any claim to which the accuracy-related and fraud penalties apply, or to any deficiency notice. However, the PATH Act inadvertently failed to state the effective date for the rule providing a reasonable cause exception for erroneous claims for refund or credit.

#### New Federal Law (IRC sections 6664 and 6676)

The provision states that the effective date for the rule providing a reasonable cause exception for erroneous claims for refund or credit is for claims filed after the date of enactment of the PATH Act.

#### Effective Dates

The amendments made by this section are effective as if included in the provision of the PATH Act to which they relate.

#### California Law (R&TC section 19164)

### **Underpayment Penalties**

California generally conforms to federal accuracy-related and fraud penalties, and to the definition of an underpayment for purposes of those penalties, as of the specified date of conformity of January 1, 2015.<sup>624</sup> Thus, for purposes of these penalties, California does not conform to this provision.

Under California law, no accuracy-related penalty or fraud penalty may be imposed to the extent that a refundable credit reduces the tax imposed below zero.

### **Erroneous Claims**

California does not conform to the penalty on erroneous claims.

#### Impact on California Revenue

Not applicable.

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<sup>623</sup> IRC section 6676.

<sup>624</sup> R&TC section 19164(d)(1) conforms to IRC section 6664 as of the specified date of January 1, 2015, except as otherwise provided.

I. Making American Opportunity Tax Credit Permanent (PATH Act sections 102, 206, 207, 208, and 211)

Background

*American Opportunity Tax Credit (AOTC)*

The AOTC refers to modifications to the Hope Credit that apply for taxable years beginning in 2009 through 2017. The maximum allowable modified credit is \$2,500 per eligible student per year for qualified tuition and related expenses paid for each of the first four years of the student's post-secondary education in a degree or certificate program. The modified credit rate is 100 percent on the first \$2,000 of qualified tuition and related expenses, and 25 percent on the next \$2,000 of qualified tuition and related expenses. For purposes of the modified credit, the definition of qualified tuition and related expenses is expanded to include course materials.

The modified credit is available with respect to an individual student for four years, provided that the student has not completed the first four years of post-secondary education before the beginning of the fourth taxable year. Thus, the modified credit, in addition to other modifications, extends the application of the Hope Credit to two more years of post-secondary education.

The modified credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between \$80,000 and \$90,000 (\$160,000 and \$180,000 for married taxpayers filing a joint return). The modified credit may be claimed against a taxpayer's AMT liability.

Forty percent of a taxpayer's otherwise allowable modified credit is refundable. However, no portion of the modified credit is refundable if the taxpayer claiming the credit is a child to whom IRC section 1(g) applies for such taxable year (generally, any child who has at least one living parent does not file a joint return; and is either under age 18 or under age 24, and a student providing less than one-half of his or her own support).

The PATH Act:

- Made the modifications to the Hope Credit, now known as the AOTC, permanent.
- Prevented retroactive claims of the AOTC.
- Applied due diligence requirements to paid preparers of AOTC claims similar to those applicable to EITC claims.
- Applied to the AOTC the disallowance rules that apply to the EITC.
- Modified the reporting requirements applicable to the AOTC by requiring taxpayers claiming the AOTC to provide the employer identification number of the educational institution attended by the individual to whom the credit relates, and educational institution requirements under IRC section 6050S to provide its employer identification number on the Form 1098-T.<sup>625</sup>

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<sup>625</sup> This is already required under the Treas. Reg. See Treas. Reg. sections 1.6050S-1(b)(2)(ii)(A) and 1.6050S-1(b)(3)(ii)(A).

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New Federal Law (IRC section 25A)

The provision eliminated unnecessary language and consolidated the provisions of IRC section 25A.

Effective Dates

The amendments made by this section are effective as if included in the provision of the PATH Act to which they relate.

California Law (None)

California does not conform to the federal AOTC.

Impact on California Revenue

Not applicable.

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m. Restriction on Tax-Free Distributions Involving Real Estate Investment Trusts (REITs) (PATH Act section 311)

Background

A corporation generally is required to recognize gain on the distribution of property (including stock of a subsidiary) to its shareholders as if the corporation had sold such property for its fair market value.<sup>626</sup> In addition, the shareholders receiving the distributed property are ordinarily treated as receiving a dividend equal to the value of the distribution (to the extent of the distributing corporation's earnings and profits),<sup>627</sup> or capital gain in the case of a stock buyback that significantly reduces the shareholder's interest in the parent corporation.<sup>628</sup>

An exception to these rules applies if the distribution of the stock of a controlled corporation satisfies the requirements of IRC section 355. If all the requirements are satisfied, there is no tax to the distributing corporation or to the shareholders on the distribution.

One requirement to qualify for tax-free treatment under IRC section 355 is that both the distributing corporation and the controlled corporation must be engaged immediately after the distribution in the active conduct of a trade or business that has been conducted for at least five years and was not acquired in a taxable transaction during that period (the "active business test").<sup>629</sup>

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<sup>626</sup> IRC section 311(b).

<sup>627</sup> IRC section 301(b)(1) and (c)(1).

<sup>628</sup> IRC section 302(a) and (b)(2).

<sup>629</sup> IRC section 355(b).



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For this purpose, the active business test is satisfied only if (1) immediately after the distribution, the corporation is engaged in the active conduct of a trade or business, or (2) immediately before the distribution, the corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.<sup>630</sup> For this purpose, the active business test is applied by reference to the relevant affiliated group rather than on a single corporation basis. For the parent distributing corporation, the relevant affiliated group consists of the distributing corporation as the common parent and all corporations affiliated with the distributing corporation through stock ownership described in IRC section 1504(a)(1) (regardless of whether the corporations are otherwise includible corporations under IRC section 1504(b)),<sup>631</sup> immediately after the distribution. The relevant affiliated group for a controlled distributed subsidiary corporation is determined in a similar manner (with the controlled corporation as the common parent).

In determining whether a corporation is directly engaged in an active trade or business that satisfies the requirement, IRS ruling practice formerly required that the value of the gross assets of the trade or business being relied on must ordinarily constitute at least five percent of the total fair market value of the gross assets of the corporation directly conducting the trade or business.<sup>632</sup> The IRS suspended this specific rule in connection with its general administrative practice of moving IRS resources away from advance rulings on factual aspects of IRC section 355 transactions in general.<sup>633</sup>

IRC section 355 does not apply to an otherwise qualifying distribution if, immediately after the distribution, either the distributing or the controlled corporation is a disqualified investment corporation and any person owns a 50 percent interest in such corporation and did not own such an interest before the distribution. A disqualified investment corporation is a corporation of which two-thirds or more of its asset value is comprised of certain passive investment assets. Real estate is not included as such an asset.<sup>634</sup>

A REIT is generally ineligible to participate in a tax-free spin-off as either a distributing or controlled corporation under IRC section 355. There are two exceptions, however. First, the general rule does not apply if, immediately after the distribution, both the distributing and the controlled corporations are REITs. Second, a REIT may spin off a taxable REIT subsidiary (TRS)

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<sup>630</sup> IRC section 355(b)(1).

<sup>631</sup> IRC section 355(b)(3).

<sup>632</sup> Revenue Procedure 2003-3, section 4.01(30), 2003-1 I.R.B. 113.

<sup>633</sup> Revenue Procedure 2003-48, 2003-29 I.R.B. 86. Since then, the IRS discontinued private rulings on whether a transaction generally qualifies for nonrecognition treatment under IRC section 355. Nonetheless, the IRS may still rule on certain significant issues. See Revenue Procedure 2015-1, 2015-1 I.R.B. 1; Revenue Procedure 2015-3, 2015-1 I.R.B. 129. More recently, the IRS announced that it will not rule in certain situations in which property owned by any distributing or controlled corporation becomes the property of a RIC or a REIT; however, the IRS stated that the policy did not extend to situations in which, immediately after the date of the distribution, both the distributing and controlled corporation will be RICs, or both of such corporations will be REITs, and there is no plan or intention on the date of the distribution for either the distributing or the controlled corporation to cease to be a RIC or a REIT. See Revenue Procedure 2015-43, 2015-40 I.R.B. 467.

<sup>634</sup> IRC section 355(g).

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if (1) the distributing corporation has been a REIT at all times during the three-year period ending on the date of the distribution, (2) the controlled corporation has been a TRS of the REIT at all times during such period, and (3) the REIT has had control (as defined in IRC section 368(c)<sup>635</sup> determined by taking into account stock owned directly or indirectly, including through one or more partnerships, by the REIT) of the TRS at all times during such period.

A controlled corporation is treated as meeting the control requirements if the stock of such corporation was distributed by a TRS in a transaction to which IRC section 355 (or so much of IRC section 356 as relates to IRC section 355) applies and the assets of such corporation consist solely of the stock or assets held by one or more TRSs of the distributing corporation meeting the control requirements noted above. For this purpose, control of a partnership means ownership of both 80 percent of the profits and capital interests.

If a corporation that is not a REIT was a distributing or controlled corporation with respect to any distribution to which IRC section 355 applied, such corporation (and any successor corporation) is ineligible to make a REIT election for any taxable year beginning before the end of the 10-year period beginning on the date of such distribution.

### New Federal Law (IRC sections 355)

The provision clarifies that, for purposes of IRC section 355(h)(2)(B), control of a partnership means ownership of *at least* (emphasis added) 80 percent of both the profits and capital interests. That is, control is not limited to exactly 80 percent ownership.

### Effective Dates

The amendments made by this section shall take effect as if included in the provision of the PATH Act to which they relate.

### California Law (R&TC sections 24451, 24870, 24872, 24872.4, 24872.6, and 24872.7)

California generally conforms to federal REIT rules as of the specified date of January 1, 2015,<sup>636</sup> with modifications.<sup>637</sup> California also conforms to federal rules relating to distributions of stock and securities of a controlled corporation, as of the specified date of January 1, 2015.<sup>638</sup> Thus, California does not conform to this provision's changes to IRC section 355 that clarify how a REIT becomes generally ineligible to participate in a tax-free spin-off as either a distributing or controlled corporation under IRC section 355.

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<sup>635</sup> Under IRC section 368(c), the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.

<sup>636</sup> R&TC section 24870 conforms to Subchapter M of Chapter 1 of the IRC (IRC sections 851-860G), relating to RICs and REITs, as of the specified date of January 1, 2015, except as otherwise provided.

<sup>637</sup> R&TC sections 24872, 24872.4, 24872.6, and 24872.7.

<sup>638</sup> R&TC section 24451 conforms to Subchapter C of Chapter 1 of Subtitle A of the IRC (IRC sections 301-385), relating to corporate distributions and adjustments, as of the specified date of January 1, 2015, except as otherwise provided.

Impact on California Revenue

Not applicable.

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n. Ancillary Personal Property of a REIT (PATH Act section 318)

Background

**75-Percent Income Test**

Among other requirements, at least 75 percent of a REIT's gross income in each taxable year must consist of real estate related income. Such income includes: rents from real property; income from the sale or exchange of real property (including interests in real property) that is not stock in trade, inventory, or held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business; interest on mortgages secured by real property or interests in real property; and certain income from foreclosure property (the "75-percent income test"). Amounts attributable to most types of services provided to tenants (other than certain "customary services"), or to more than specified amounts of personal property, are not qualifying rents.

The IRC definition of rents from real property<sup>639</sup> includes rent attributable to personal property which is leased under, or in connection with, a lease of real property, but only if the rent attributable to such property for the taxable year does not exceed 15 percent of the total rent for the taxable year attributable to both the real and personal property leased under, or in connection with, such lease.<sup>640</sup>

For purposes of determining whether interest income is from a mortgage secured by real property, Treas. Reg. provide that where a mortgage covers both real property and other property, an apportionment of the interest must be made. If the loan value of the real property is equal to or exceeds the amount of the loan, then the entire interest income is apportioned to the real property. However, if the amount of the loan exceeds the loan value of the real property, then the interest income apportioned to the real property is an amount equal to the interest income multiplied by a fraction, the numerator of which is the loan value of the real property and the denominator of which is the amount of the loan.<sup>641</sup> The remainder of the interest income is apportioned to the other property.

The loan value of real property is defined as the fair market value of the property determined as of the date on which the commitment by the REIT to make the loan becomes binding on the REIT. In the case of a loan purchased by a REIT, the loan value of the real property is the fair market value

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<sup>639</sup> IRC section 856(d).

<sup>640</sup> IRC section 856(d)(1)(C).

<sup>641</sup> Treas. Reg. section 1.856-5(c)(1). The amount of the loan for this purpose is defined as the highest principal amount of the loan outstanding during the taxable year. Treas. Reg. section 1.856-5(c)(3).

of the real property determined as of the date on which the commitment of the REIT to purchase the loan becomes binding.<sup>642</sup>

### **75-Percent Asset Test**

At the close of each quarter of the taxable year, at least 75 percent of the value of a REIT's total assets must be represented by real estate assets, cash and cash items, and government securities.

Real estate assets generally mean real property (including interests in real property and interests in mortgages on real property) and shares (or transferable certificates of beneficial interest) in other REITs.

Certain ancillary personal property leased with real property is treated as real property for purposes of the 75-percent asset test, applying the same threshold that applies under present law for purposes of determining rents from real property under IRC section 856(d)(l)(C) for purposes of the 75-percent income test.

If this test is satisfied, the REIT would be not be taxed on the dividends and capital gains distributed to its shareholders.

### **Obligation Secured by Mortgage on Both Real and Personal Property**

In the case of an obligation secured by a mortgage on both real property and personal property, if the fair market value of such personal property does not exceed 15 percent of the total fair market value of all such property, such personal property is treated as real property for purposes of the 75-percent income and 75-percent asset test computations.<sup>643</sup> In making this determination, the fair market value of all property (both personal and real) is determined at the same time and in the same manner as the fair market value of real property is determined for purposes of apportioning interest income between real property and personal property under the rules for determining whether interest income is from a mortgage secured by real property.

### **New Federal Law (IRC section 856)**

As amended by the PATH Act, IRC section 856(c)(9) treats ancillary personal property as a real estate asset for purposes of the REIT 75-percent asset test to the extent that rents attributable to such ancillary personal property are treated, under a separate provision, as rents from real property.

The provision makes two conforming changes with respect to the REIT income tests. First, the provision treats gain from the sale or disposition of such ancillary personal property as gain from the sale or disposition of a real estate asset for purposes of the REIT income tests. Second, the provision treats gain from the sale or disposition of certain obligations secured by mortgages on

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<sup>642</sup> Special rules apply to construction loans. Treas. Reg. section 1.856-5(c)(2).

<sup>643</sup> IRC section 856(c)(3)(B) and (4)(A).

both real property and personal property as gain from the sale or disposition of real property for purposes of the REIT income tests.

### Effective Dates

The amendments made by this section shall take effect as if included in the provision of the PATH Act to which they relate.

### California Law (R&TC sections 24870, 24872, 24872.4, 24872.6, and 24872.7)

California generally conforms to federal REIT rules as of the specified date of January 1, 2015,<sup>644</sup> with modifications.<sup>645</sup> However, California law provides that a corporation, trust, or association that is a REIT for any taxable year for federal purposes is automatically a REIT for California purposes for the same taxable year.<sup>646</sup> Conversely, a corporation, trust, or association that is not a REIT for any taxable year for federal purposes is automatically not a REIT for California purposes for the same taxable year.<sup>647</sup>

Although California does not conform to the changes made by the PATH Act or the related technical corrections, under California law, for any taxable year that a trust qualifies for REIT status for federal purposes is determinative for California purposes. Thus, any trust that qualifies as a REIT for federal purposes will automatically qualify as a REIT for California purposes.

### Impact on California Revenue

Baseline.

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#### o. Section 529 Programs and Qualified ABLE Programs (PATH Act section 302(b))

### Background

#### **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 the beneficiary's

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<sup>644</sup> R&TC section 24870 conforms to Subchapter M of Chapter 1 of the IRC (IRC sections 851-860G), relating to RICs and REITs, as of the specified date of January 1, 2015, except as otherwise provided.

<sup>645</sup> R&TC sections 24872, 24872.4, 24872.6, and 24872.7.

<sup>646</sup> R&TC section 24872.6(a).

<sup>647</sup> R&TC section 24872.6(b).

qualified higher education expenses (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.<sup>648</sup> 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 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 other than the designated beneficiary. Qualified tuition accounts or contracts generally require the designation of a person (generally referred to as an “account owner”)<sup>649</sup> 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.

Beginning after December 31, 2017, plans may distribute no more than \$10,000 in expenses for tuition incurred during the taxable year in connection with the enrollment or attendance of the

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<sup>648</sup> 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.

<sup>649</sup> 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.



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, 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.

### *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).

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.

### **Qualified ABLE Programs**

The IRC provides for a tax-favored savings program intended to benefit disabled individuals, known as qualified ABLE programs.<sup>650</sup> 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

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<sup>650</sup> IRC section 529A.



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in excess of the annual gift tax exemption amount under section 2503(b) of the IRC. For 2017, this is \$14,000.<sup>651</sup> 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).

For taxable years beginning after December 22, 2017, and before January 1, 2026, the ABLE account contribution limitation is increased 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. 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 designated beneficiary's compensation for the taxable year.

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 of earnings on the account.<sup>652</sup> 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<sup>653</sup> 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,<sup>654</sup> 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.

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<sup>651</sup> 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.

<sup>652</sup> The rules of IRC section 72 apply in determining the portion of a distribution that consists of earnings.

<sup>653</sup> For instance, if a designated beneficiary were to relocate to a different state.

<sup>654</sup> In which case the contributor ABLE account must be closed 60 days after the transfer to the new ABLE account is made.

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.

### *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<sup>655</sup> 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.<sup>656</sup>

### *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 approved by the Secretary under regulations and consistent with the purposes of IRC 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

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<sup>655</sup> These are benefits, respectively, under Title II or Title XVI of the Social Security Act.

<sup>656</sup> No inference may be drawn from a disability certification for purposes of eligibility for Social Security, SSI or Medicaid benefits.

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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.

### *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 Supplemental Security Income 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 529A)

For IRC section 529 qualified tuition programs, the PATH Act repealed the rules providing that IRC section 529 accounts must be aggregated for purposes of calculating the amount of a distribution that is included in a taxpayer's income. Though PATH Act section 303 modified certain rules for qualified ABLE programs, it did not make a parallel change to the rules for distributions from ABLE accounts.

The provision makes a parallel change that conforms the treatment of multiple distributions during a taxable year from an ABLE account in IRC section 529A to the treatment of multiple distributions during a taxable year from an IRC section 529 account.

### Effective Dates

The amendments made by this section shall take effect as if included in the provision of the PATH Act to which they relate.

### California Law (R&TC section 17140.4)

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,<sup>657</sup> with modifications, thus does not conform to the federal change to the treatment of multiple distributions from an ABLE account for purposes of determining whether, if any, of such distributions must be aggregated for purposes of calculating the amount of a distribution that is included in a taxpayer's income.

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<sup>657</sup> R&TC section 17024.5.

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Impact on California Revenue

Estimated Conformity Revenue Impact of Section 529 Programs and Qualified ABLE Programs (PATH Act section 302(b)) For Taxable Years Beginning On or After January 1, 2019 Enactment Assumed After June 30, 2019			
2018-19	2019-20	2020-21	2021-22
N/A	(\$4,000)	(\$2,000)	(\$3,000)

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p. Exception from Foreign Investment in U.S. Real Property Tax Act for Certain Stock of REITs (PATH Act section 322)

Background

**General Rules Relating to the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA)<sup>658</sup>**

A foreign person that is not engaged in the conduct of a trade or business in the U.S. generally is not subject to any U.S. tax on capital gain from U.S. sources, including capital gain from the sale of stock or other capital assets.<sup>659</sup>

However, FIRPTA generally treats a foreign person's gain or loss from the disposition of a U.S. real property interest (USRPI) as income that is effectively connected with the conduct of a U.S. trade or business, and thus taxable at the income tax rates applicable to U.S. persons, including the rates for net capital gain.<sup>660</sup> With certain exceptions, if a foreign corporation distributes a USRPI, gain is recognized on the distribution (including a distribution in redemption or liquidation) of a USRPI, in an amount equal to the excess of the fair market value of the USRPI (as of the time of distribution) over its adjusted basis.<sup>661</sup> A foreign person subject to tax on a FIRPTA gain is required to file a U.S. tax return under the normal rules relating to receipt of income effectively connected with a U.S. trade or business.<sup>662</sup>

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<sup>658</sup> Public Law 96-499. The rules governing the imposition and collection of tax under FIRPTA are contained in a series of provisions enacted in 1980 and subsequently amended. See IRC sections 897, 1445, 6039C, and 6652(f).

<sup>659</sup> IRC sections 871(b) and 882(a). Property is treated as held by a person for use in connection with the conduct of a trade or business in the U.S., even if not so held at the time of sale, if it was so held within 10 years prior to the sale. IRC section 864(c)(7). Also, all gain from an installment sale is treated as from the sale of property held in connection with the conduct of such a trade or business if the property was so held during the year in which the installment sale was made, even if the recipient of the payments is no longer engaged in the conduct of such trade or business when the payments are received. IRC section 864(c)(6).

<sup>660</sup> IRC section 897(a).

<sup>661</sup> IRC section 897(d). In addition, such gain may also be subject to the branch profits tax at a 30-percent rate (or lower treaty rate).

<sup>662</sup> In addition, IRC section 6039C authorizes regulations that would require a return reporting foreign direct investments in U.S. real property interests. No such regulations have been issued, however.

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The payor of amounts that FIRPTA treats as effectively connected with a U.S. trade or business (“FIRPTA income”) to a foreign person generally is required to withhold U.S. tax from the payment.<sup>663</sup>

Withholding generally is:

- 10 percent of the sales price, in the case of a direct sale by the foreign person of a USRPI (but withholding is not required in certain cases, including on any sale of stock that is regularly traded on an established securities market.<sup>664</sup>)
- 10 percent of the amount realized by the foreign shareholder in the case of certain distributions by a corporation that is or has been a U.S. real property holding corporation during the applicable testing period.<sup>665</sup>
- 35 percent of the amount of a distribution to a foreign person of net proceeds attributable to the sale of a USRPI from an entity such as a partnership, REIT, or RIC.<sup>666</sup>

The foreign person can request a refund with its U.S. tax return, if appropriate, based on that person’s total U.S. effectively-connected income and deductions (if any) for the taxable year.

*U.S. Real Property Holding Corporations (USRPHCs) and Five-Percent Public Shareholder Exception*

U.S. real property interests (USRPIs) include not only interests in real property located in the U.S. or the U.S. Virgin Islands, but also stock of a USRPHC, generally defined as any domestic corporation, unless the taxpayer establishes that the fair market value of the corporation’s USRPIs was less than 50 percent of the combined fair market value of all its real property interests (U.S. and worldwide) and all its assets used or held for use in a trade or business, at all times during a “testing period,” which is the shorter of the duration of the taxpayer’s ownership of the stock after June 18, 1980, or the five-year period ending on the date of disposition of the stock.<sup>667</sup>

Under an exception, even if a corporation is a USRPHC, a shareholder’s shares of a class of stock that is regularly traded on an established securities market are not treated as USRPIs if the shareholder holds (applying attribution rules) no more than five percent of that class of stock at any time during the testing period.<sup>668</sup> Among other things, the relevant attribution rules require attribution between a corporation and a shareholder that owns five percent or more in value of

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<sup>663</sup> IRC section 1445(a).

<sup>664</sup> IRC section 1445(b)(6).

<sup>665</sup> IRC section 1445(e)(3). Withholding at 10 percent of a gross amount may also apply in certain other circumstances under regulations. See IRC section 1445(e)(4) and (5).

<sup>666</sup> IRC section 1445(e)(6) and Treas. Reg. thereunder. The Treasury Department is authorized to issue regulations that would reduce the 35 percent withholding on distributions to 20 percent during the time that the maximum income tax rate on dividends and capital gains of U.S. persons is 20 percent.

<sup>667</sup> IRC section 897(c)(1) and (2).

<sup>668</sup> IRC section 897(c)(3). The constructive ownership attribution rules are specified in IRC section 897(c)(6)(C).

the stock of such corporation.<sup>669</sup> The attribution rules also attribute stock ownership between spouses and between children, grandchildren, parents, and grandparents.

### **Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) Rules for Foreign Investment through Real Estate Investment Trusts (REITs) and Regulated Investment Companies (RICs)**

Special FIRPTA rules apply to foreign investment through a “qualified investment entity,” which includes any REIT and certain RICs that invest largely in USRPIs (including stock of one or more REITs).<sup>670</sup>

#### *Stock of Domestically Controlled Qualified Investment Entities Not a U.S. Real Property Interest (USRPI)*

If a qualified investment entity is “domestically controlled” (defined to mean that less than 50 percent in value of the qualified investment entity has been owned (directly or indirectly) by foreign persons during the relevant testing period),<sup>671</sup> stock of such entity is not a USRPI and a foreign shareholder can sell the stock of such entity without being subject to tax under FIRPTA, even if the stock would otherwise be stock of a USRPHC. Treas. Reg. provide that for purposes of determining whether a REIT is domestically controlled, the actual owner of REIT shares is the “person who is required to include in his return the dividends received on the stock.”<sup>672</sup> The IRS has issued a private letter ruling concluding that the term “directly or indirectly” for this purpose does not require looking through corporate entities that, in the facts of the ruling, were represented to be fully taxable domestic corporations for U.S. federal income tax purposes “and not otherwise a REIT, RIC, hybrid entity, conduit, disregarded entity, or other flow-through or look-through entity.”<sup>673</sup>

#### *FIRPTA Applies to Qualified Investment Entity (REIT and Certain RIC) Distributions Attributable to Gain from Sale or Exchange of USRPIs, Except for Distributions to Certain Five-Percent or Smaller Shareholders*

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<sup>669</sup> If a person owns, directly or indirectly, five percent or more in value of the stock in a corporation, such person is considered as owning the stock owned directly or indirectly by or for such corporation, in that proportion which the value of the stock such person so owns bears to the value of all the stock in such corporation.

IRC section 318(c)(2)(C) as modified by IRC section 897(c)(6)(C). Also, if five percent or more in value of the stock in a corporation is owned directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person. IRC section 318(c)(3)(C) as modified by IRC section 897(c)(6)(C).

<sup>670</sup> IRC section 897(h)(4)(A)(i). The provision including certain RICs in the definition of qualified investment entity previously expired December 31, 2014. See section 133 of this Act, however, which makes that provision permanent.

<sup>671</sup> The testing period for this purpose is the shorter of (i) the period beginning on June 19, 1980, and ending on the date of disposition or distribution, as the case may be, (ii) the five-year period ending on the date of the disposition or distribution, as the case may be, or (iii) the period during which the qualified investment entity was in existence. IRC section 897(h)(4)(D).

<sup>672</sup> Treas. Reg. section 1.897-1(c)(2)(i) and -8(b).

<sup>673</sup> PLR 200923001. A private letter ruling may be relied upon only by the taxpayer to which it is issued. However, private letter rulings provide some indication of administrative practice.



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A distribution by a REIT or other qualified investment entity, to the extent attributable to gain from the entity's sale or exchange of USRPIs, is treated as FIRPTA income.<sup>674</sup> The FIRPTA character is retained if the distribution occurs from one qualified investment entity to another, through a tier of REITs or RICs.<sup>675</sup> An IRS notice (Notice 2007-55) states that this rule retaining the FIRPTA income character of distributions attributable to the sale of USRPIs applies to any distributions under IRC sections 301, 302, 331, and 332 (*i.e.*, to dividend distributions, distributions treated as sales or exchanges of stock by the investor, and both non-liquidating and liquidating distributions) and that the IRS will issue regulations to that effect.<sup>676</sup>

There is an exception to this rule in the case of distributions to certain public shareholders. If an investor has owned no more than five percent of a class of stock of a REIT or other qualified investment entity that is regularly traded on an established securities market located in the U.S. during the one-year period ending on the date of the distribution, then amounts attributable to gain from entity sales or exchanges of USRPIs can be distributed to such a shareholder without being subject to FIRPTA tax.<sup>677</sup> Such distributions that are dividends are treated as dividends from the qualified investment entity,<sup>678</sup> and thus generally would be subject to U.S. dividend withholding tax (as reduced under any applicable treaty), but are not treated as income effectively connected with the conduct of a U.S. trade or business. An IRS Chief Counsel advice memorandum concludes that such distributions which are not dividends (because made in a complete liquidation of a REIT) are not subject to tax under the FIRPTA.<sup>679</sup>

#### REIT Stock Dispositions and Distributions that Occur on or After December 18, 2015

##### **Exception from FIRPTA for Certain REIT Stock**

In the case of REIT stock only, the provision increases from five percent to 10 percent the maximum stock ownership a shareholder may have held, during the testing period, of a class of stock that is publicly traded, to avoid having that stock be treated as a USRPI on disposition.

The provision likewise increases from five percent to 10 percent the percentage ownership threshold that, if not exceeded, results in treating a distribution to holders of publicly traded REIT stock, attributable to gain from sales or exchanges of USRPIs, as a dividend, rather than as FIRPTA gain.

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<sup>674</sup> IRC section 897(h)(1).

<sup>675</sup> In 2006, the Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA"), Public Law 109-222, section 505, specified the retention of this FIRPTA character on a distribution to an upper-tier qualified investment entity, and added statutory withholding requirements.

<sup>676</sup> Notice 2007-55, 2007-2 C.B. 13. The Notice also states that in the case of a foreign government investor, because FIRPTA income is treated as effectively connected with the conduct of a U.S. trade or business, proceeds distributed by a qualified investment entity from the sale of USRPIs are not exempt from tax under IRC section 892. The Notice cites and compares existing temporary regulations and indicates that Treasury will apply those regulations as well to certain distributions. See Temp. Treas. Reg. sections 1.892-3T, 1.897-9T(e), and 1.1445-10T(b).

<sup>677</sup> IRC section 897(h)(1), second sentence.

<sup>678</sup> IRC section 852(b)(3)(E) and 857(b)(3)(F).

<sup>679</sup> AM2008-003, February 15, 2008.



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The attribution rules of IRC section 897(c)(6)(C) retain the present-law rule that requires attribution between a shareholder and a corporation if the shareholder owns more than five percent of a class of stock of the corporation. The attribution rules now apply, however, to the determination of whether a person holds more than 10 percent of a class of publicly traded REIT stock.

The provision also specifies that REIT stock held by a qualified shareholder, including stock held indirectly through one or more partnerships, is not a U.S. real property interest in the hands of such qualified shareholder, except to the extent that an investor in the qualified shareholder (other than an investor that is a qualified shareholder) holds more than 10 percent of that class of stock of the REIT (determined by application of the constructive ownership rules of IRC section 897(c)(6)(C)). Thus, so long as the “more than 10 percent” rule is not exceeded, a qualified shareholder may own and dispose of any amount of stock of a REIT (including stock of a privately-held, non-domestically controlled REIT that is owned by such qualified shareholder) without triggering the application of FIRPTA.

If an investor in the qualified shareholder (other than an investor that is a qualified shareholder) directly, indirectly, or constructively holds more than 10 percent of such class of REIT stock (an “applicable investor”), then a percentage of the REIT stock held by the qualified shareholder equal to the applicable investor’s percentage ownership of the qualified shareholder is treated as a USRPI in the hands of the qualified shareholder and is subject to FIRPTA. In that case, an amount equal to such percentage multiplied by the disposition proceeds and REIT distribution proceeds attributable to underlying USRPI gain is treated as FIRPTA gain in the hands of the qualified shareholder.

The provision is intended to override in certain cases one of the conclusions reached in AM2008-003.<sup>680</sup> Specifically, the provision contains special rules with respect to certain distributions that are treated as a sale or exchange of REIT stock under IRC section 301(c)(3), 302, or 331 with respect to a qualified shareholder. Any such amounts attributable to an applicable investor are ineligible for the FIRPTA exception for qualified shareholders, and thus are subject to FIRPTA. Any such amounts attributable to other investors are treated as a dividend received from a REIT for purposes of U.S. dividend withholding tax and the application of income tax treaties, notwithstanding their general treatment under the IRC as capital gain.

For purposes of this provision, a qualified shareholder is defined as a foreign person that (1) either is eligible for the benefits of a comprehensive income tax treaty which includes an exchange of information program and whose principal class of interests is listed and regularly traded on one or more recognized stock exchanges (as defined in such comprehensive income tax treaty), or is a foreign partnership that is created or organized under foreign law as a limited partnership in a jurisdiction that has an agreement for the exchange of information with respect to taxes with the U.S. and has a class of limited partnership units representing greater than 50 percent of the value of all the partnership units that is regularly traded on the NYSE or NASDAQ markets, (2) is a qualified collective investment vehicle (as defined below), and (iii) maintains records on the identity of each person who, at any time during the foreign person’s taxable year, is

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<sup>680</sup> IRS Memorandum Number AM2008-003, issued February 15, 2008, Treatment of Certain Distributions in Complete Liquidation by a REIT.

the direct owner of 5 percent or more of the class of interests or units (as applicable) described in (i), above.

For purposes of this provision, a qualified collective investment vehicle is defined as a foreign person that (1) would be eligible for a reduced rate of withholding under the comprehensive income tax treaty described above, even if such person holds more than 10 percent of the stock of such REIT,<sup>681</sup> (2) is publicly traded, treated as a partnership under the IRC, is a withholding foreign partnership, and would be treated as a USRPHC if it were a domestic corporation, or (3) is designated as such by the Secretary of the Treasury and is either (a) fiscally transparent within the meaning of IRC section 894, or (b) required to include dividends in its gross income, but is entitled to a deduction for distributions to its investors.

The provision also contains rules with respect to partnership allocations of USRPI gains to applicable investors. If an applicable investor's proportionate share of USRPI gain for the taxable year exceeds such partner's distributive share of USRPI gain for the taxable year then such partner's distributive share of non-USRPI income or gain is recharacterized as USRPI gain for the taxable year in the amount that the distributive share of USRPI gain exceeds the proportionate share of USRPI gain. For purposes of these partnership allocation rules, USRPI gain is defined to include the net of gain recognized on disposition of a USRPI, distributions from a REIT that are treated as USRPI gain, and loss from the disposition of USRPIs. An investor's proportionate share of USRPI gain is determined based on the applicable investor's largest proportionate share of income or gain for the taxable year, and if such proportionate amount may vary during the existence of the partnership, such share is the highest share the applicable investor may receive.

### **Domestically Controlled Qualified Investment Entity**

The provision redefines the term "domestically controlled qualified investment entity" to provide a number of new rules and presumptions relating to whether a qualified investment entity is domestically controlled. First, a qualified investment entity shall be permitted to presume that holders of less than five percent of a class of stock regularly traded on an established securities market in the U.S. are U.S. persons throughout the testing period, except to the extent that the qualified investment entity has actual knowledge that such persons are not U.S. persons.

Second, any stock in the qualified investment entity held by another qualified investment entity (1) which has issued any class of stock that is regularly traded on an established stock exchange, or (2) which is a RIC that issues redeemable securities (within the meaning of section 2 of the Investment Company Act of 1940) shall be treated as held by a foreign person unless such other qualified investment entity is domestically controlled (as determined under the new rules) in which case such stock shall be treated as held by a U.S. person. Finally, any stock in a qualified investment entity held by any other qualified investment entity not described in (1) or (2) of the preceding sentence shall only be treated as held by a U.S. person to the extent that the stock of such other qualified investment entity is (or is treated under the new provision as) held by a U.S. person.

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<sup>681</sup> For example, the U.S. income tax treaties with Australia and the Netherlands provide such a reduced rate of withholding under certain circumstances.

New Federal Law (IRC section 897)

The provision restates amended IRC section 897(k), making clerical corrections, and removing a repealed provision.

Further, under IRC section 897(k) as amended, the provision addresses the definition of a qualified collective investment vehicle that is eligible for benefits of a comprehensive income tax treaty with the U.S. that includes an exchange of information program. Specifically, the provision clarifies that the definition can be met only if the dividends article in the treaty imposes conditions on the benefits allowable in the case of dividends paid by a REIT.

The provision clarifies the operative date for the determination of domestic control by stating that the rule applies with respect to each testing period ending on or after the date of enactment, rather than taking effect on the date of enactment.

Effective Dates

The amendments made by this section shall take effect as if included in the provision of the PATH Act to which they relate.

California Law (None)

California generally conforms to the federal REIT rules, IRC sections 861 through 865, and 897(g) and (h). However, California does not conform to the federal REIT rules under IRC sections 856-860. In addition, California does not generally conform to the federal FIRPTA rules that treat a foreign person's gain or loss from the disposition of a USRPI as income that is effectively connected with the conduct of a U.S. trade or business, except for certain foreign corporations doing business in California. Those corporations, which have a water's-edge election in force, are required to use federal sourcing rules, such as those set forth in IRC sections 861 through 865 and 897(g) and (h), as applicable for federal purposes, to determine U.S. source income, including rules for foreign corporations. In other words, California already conforms to these changes for water's-edge purposes. With respect to corporations other than water's-edge corporations, California uses the worldwide combined reporting method of determining the income subject to California tax.

Impact on California Revenue

Not applicable.

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q. FIRPTA Exception for Qualified Foreign Pension Funds (PATH Act section 323)

Background

Under the PATH Act, if a qualified foreign pension fund or by a foreign entity wholly-owned by a qualified foreign pension fund holds any USRPI directly (or indirectly through one or more partnerships); or receives any distribution from a REIT, it is exempt from the rules of IRC section 897. A qualified foreign pension fund means any trust, corporation, or other organization or arrangement (1) which is created or organized under the law of a country other than the U.S., (2) which is established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees (or persons designated by such employees) of one or more employers in consideration for services rendered, (3) which does not have a single participant or beneficiary with a right to more than five percent of its assets or income, (4) which is subject to government regulation and provides annual information reporting about its beneficiaries to the relevant tax authorities in the country in which it is established or operates, and (5) with respect to which, under the laws of the country in which it is established or operates, (i) contributions to such organization or arrangement that would otherwise be subject to tax under such laws are deductible or excluded from the gross income of such entity or taxed at a reduced rate, or (ii) taxation of any investment income of such organization or arrangement is deferred or such income is taxed at a reduced rate.

The PATH Act also made conforming changes to IRC section 1445 to eliminate withholding on sales by qualified foreign pension funds (and their wholly-owned foreign subsidiaries) of USRPIs. The Secretary of the Treasury may provide such regulations as are necessary to carry out the purposes of the provision.

New Federal Law (IRC section 897)

The provision clarifies that, for purposes of IRC section 897, a qualified foreign pension fund is not treated as a nonresident alien individual or as a foreign corporation; in other words, in determining the U.S. income tax of a qualified foreign pension fund, IRC section 897 does not apply. Additionally, the provision specifies that an entity whose interests are held entirely by a qualified foreign pension fund is treated as such a fund.

The provision also revises the second prong of the definition to clarify that a government-established fund to provide public retirement or pension benefits may qualify, as well as a fund established by more than one employer to provide retirement or pension benefits to their employees, such as a multiple-employer or multiemployer plan. In addition, the provision makes clarifying changes to the fourth and fifth prongs of the definition.

Effective Dates

The amendments made by this section shall take effect as if included in the provision of the PATH Act to which they relate.

California Law (R&TC sections 25110-25116)

California does not generally conform to the federal FIRPTA rules that generally treat a foreign person's gain or loss from the disposition of a USRPI as income that is effectively connected with the conduct of a U.S. trade or business, except for certain foreign corporations doing business in California. Those corporations, which have a water's-edge election in force, are required to use federal sourcing rules, such as those set forth in IRC sections 861 through 865 and 897(g) and (h), as applicable for federal purposes, to determine U.S. source income, including rules for foreign corporations. In other words, California already conforms to these changes for water's-edge purposes. With respect to corporations other than water's-edge corporations, California uses the worldwide combined reporting method of determining the income subject to California tax.

Impact on California Revenue

Not applicable.

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r. Election of Certain Small Insurance Companies to Be Taxed Only on Taxable Investment Income (PATH Act section 333)

Background

Under present federal law, the taxable income of a property and casualty insurance company is the sum of the amount earned from underwriting income and investment income (including gains and other income items), reduced by allowable deductions. For this purpose, underwriting income and investment income are computed on the basis of the underwriting and investment exhibit of the annual statement approved by the National Association of Insurance Commissioners. Insurance companies are subject to tax at regular corporate income tax rates.

In lieu of the tax otherwise applicable, certain property and casualty insurance companies may elect to be taxed only on taxable investment income under IRC section 831(b). To be eligible for the election, the following premiums limitations and diversification requirements must be met.

**Premiums Limitations**

For taxable years beginning on or after December 31, 2017, the election is available to mutual and stock companies with net written premiums or direct written premiums (whichever is greater) that do not exceed \$2,200,000. This amount is indexed for inflation and rounded to the next lowest multiple of \$50,000 (in the case in which the inflation adjusted amount is not a multiple of \$50,000). For taxable years beginning in 2018, the inflation adjusted amount is \$2,300,000.

For purposes of determining whether a company meets this dollar limit, the company is treated as receiving during the taxable year amounts of net or direct written premiums that are received

during that year by all other companies that are members of the same controlled group as the company. A controlled group means any controlled group of corporations as defined in IRC section 1563(a), but applying a “more than 50 percent” threshold in lieu of the “at least 80 percent” threshold in the requirement that one of the corporations own at least 80 percent of the total combined voting power of all classes of stock entitled to vote or at least 80 percent of the total value of share of all classes of stock of each of the corporations; without treating insurance companies as a separate controlled group; and without treating life insurance companies as excluded members.<sup>682</sup>

## Diversification Requirements

In addition to the net written premiums or direct written premium amount (whichever is greater) limitation, certain diversification requirements must also be met. An insurance company can meet these in one of two ways.

### *Risk Diversification Test*

An insurance company meets the diversification requirement if no more than 20 percent of the net written premiums (or, if greater, direct written premiums) of the company for the taxable year is attributable to any one policyholder. In determining the attribution of premiums to a policyholder, all policyholders that are related<sup>683</sup> or are members of the same controlled group<sup>684</sup> are treated as one policyholder.

### *Relatedness Test*

If an insurance company does not meet the above 20-percent requirement, an alternative risk diversification requirement applies for the company to be eligible to elect IRC section 831(b) treatment.<sup>685</sup> Under this requirement, no person who holds (directly or indirectly) an interest in the company is a specified holder who holds (directly or indirectly) aggregate interests in the company that constitute a percentage of the entire interests in the company that is more than a de minimis percentage higher than the percentage of interests in the specified assets with

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<sup>682</sup> IRC sections 1563(a)(1), (a)(4), and (b)(2)(D), as modified by IRC section 831(b)(2)(B).

<sup>683</sup> For this purpose, persons are related within the meaning of IRC section 267(b) or 707(b).

<sup>684</sup> Members of the same controlled group are determined as under present law for purposes determining whether a company meets the dollar limit applicable to net written premiums (or, if greater, direct written premiums). The controlled group definition is relocated, as modified for purposes of IRC section 831, in IRC section 831(b)(2)(C).

<sup>685</sup> These added eligibility rules reflect the concern expressed by the Finance Committee upon reporting out S.905, “A Bill to Amend the Internal Revenue Code of 1986 to Increase the Limitation on Eligibility for the Alternative Tax for Certain Small Insurance Companies,” when the Committee stated, “The Committee notes that the provision does not include a related proposal that would narrow eligibility to elect the alternative tax in a manner intended to address abuse potential, but that may cause problems for certain states. The Committee therefore wants the Treasury Department to study the abuse of captive insurance companies for estate planning purposes, so Congress can better understand the scope of this problem and whether legislation is necessary to address it.” S. Rep. 114-16, April 14, 2015, page 2.



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respect to the company held (directly or indirectly) by the specified holder. Two percentage points or less is treated as de minimis, except as otherwise provided in regulations or other guidance.

An indirect interest for this purpose includes any interest held through a trust, estate, partnership, or corporation.

A specified holder means, with respect to an insurance company, any individual who holds (directly or indirectly) an interest in the insurance company and who is a spouse or lineal descendant (including by adoption) of an individual who holds an interest (directly or indirectly) in the specified assets with respect to the insurance company.

The specified assets with respect to an insurance company mean the trades or businesses, rights, or assets with respect to which the net written premiums (or direct written premiums) of the company are paid.

For example, assume that in 2017, a captive insurance company fails the risk diversification test because it has one policyholder, Business, certain of whose property and liability risks the captive covers (the specified assets). Business pays the captive \$2 million in premiums in 2017. Business is owned 70 percent by Father and 30 percent by Son. The captive is owned 100 percent by Son (whether directly, or through a trust, estate, partnership, or corporation). Son is Father's lineal descendant. Son, a specified holder, has a non-de minimis percentage greater interest in the captive (100 percent) than in the specified assets with respect to the captive (30 percent). Therefore, the captive fails the relatedness test and is ineligible to elect IRC section 831(b) treatment.

If, by contrast, all the above facts were the same except that Son owned 30 percent and Father owned 70 percent of the captive, Son would not have a non-de minimis percentage greater interest in the captive (30 percent) than in the specified assets with respect to the captive (30 percent). The captive would meet the relatedness diversification requirement for eligibility to elect IRC section 831(b) treatment.

Any insurance company for which an IRC section 831(b) election is in effect for a taxable year must report information required by the Secretary relating to the diversification requirements.

### New Federal Law (IRC section 831)

The provision clarifies the risk diversification rule established under the PATH Act by adding a look-through rule with respect to an intermediary (for example, an aggregate fund). Specifically, the provision specifies that in the case of reinsurance or any fronting, intermediary, or similar arrangement, a policyholder means each policyholder of the underlying direct written insurance with respect to the reinsurance or arrangement.

The provision also clarifies the determination of percentages under the relatedness diversification rule established under the PATH Act by specifying that the determination is made based on relevant specified assets. relevant specified assets are defined (with respect to any specified holder with respect to any insurance company) to mean the aggregate amount of the specified assets, with respect to the insurance company, any interest in which is held directly or indirectly by



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a spouse or specified relation. A specified relation is a lineal descendent (including by adoption) of an individual who holds, directly or indirectly, an interest in the insurance company, and the lineal descendant's spouse. Thus, for example, a specified relation of an individual includes the individual's step-children. The provision further clarifies that relevant specified assets do not include any specified asset that was acquired by the spouse or specified relation by bequest, devise, or inheritance from a decedent for a two-year period.

A specified holder is defined to include a lineal descendent (including by adoption) of an individual who holds, directly or indirectly, an interest in the insurance company, and the lineal descendant's spouse. Thus, a specified holder includes an individual's step-children. A specified holder is defined also to include a non-U.S.-citizen spouse of an individual who holds, directly or indirectly, an interest in the specified assets with respect to the insurance company. A non-U.S.-citizen spouse would generally not be an eligible recipient for purposes of the unified estate and gift tax marital deduction, for example, and so assets passing to such a spouse from such an individual would not be deductible for estate and gift tax purposes. By contrast, a U.S. citizen spouse could receive assets from the individual without giving rise to estate tax or gift tax with respect to those assets.

Treasury Department guidance under the provision may provide that factors such as ownership, premiums, gross revenue, and factors taken into account under applicable state law for assessing risk are taken into account, to the extent this is consistent with the purpose of the provision to accurately determine percentages based on the real economic arrangement among the parties.

Effective Dates

The amendments made by this section shall take effect as if included in the provision of the PATH Act to which they relate.

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, pay the gross premiums tax that is jointly administered by the California State Board of Equalization, California Department of Tax and Fee Administration, Department of Insurance, and the State Controller's Office.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
102	Amendment Relating to Consolidated Appropriations Act, 2016

## Background

### **In General**

A deduction is allowed from taxable income (or, in the case of an individual, AGI<sup>686</sup>) 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.<sup>687</sup>

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.<sup>688</sup>

Domestic production gross receipts generally are a taxpayer's gross receipts that are derived from: (1) any sale, exchange, or other disposition, or any lease, rental, or license, of qualifying production property<sup>689</sup> that was manufactured, produced, grown or extracted by the taxpayer in whole or in significant part within the U.S.;<sup>690</sup> (2) any sale, exchange, or other disposition, or any lease, rental, or license, of qualified film<sup>691</sup> produced by the taxpayer; (3) any lease, rental, license, sale, exchange, or other disposition of electricity, natural gas, or potable water produced by the taxpayer in the U.S.; (4) construction of real property performed in the U.S. by a taxpayer in the ordinary course of a construction trade or business; or (5) engineering or architectural services performed in the U.S. for the construction of real property located in the U.S..<sup>692</sup>

The deductible amount 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.<sup>693</sup>

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<sup>686</sup> For this purpose, AGI is determined after application of IRC sections 86, 135, 137, 219, 221, 222, and 469, without regard to the IRC section 199 deduction. IRC section 199(d)(2).

<sup>687</sup> IRC section 199.

<sup>688</sup> 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 Treas. Reg. 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.

<sup>689</sup> Qualifying production property generally includes any tangible personal property, computer software, and sound recordings. IRC section 199(c)(5).

<sup>690</sup> 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), as extended by section 170 of the Act. 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).

<sup>691</sup> Qualified film includes any motion picture film or videotape (including live or delayed television programming, but not including certain sexually explicit productions) if 50 percent or more of the total compensation relating to the production of the film (including compensation in the form of residuals and participations) constitutes compensation for services performed in the U.S. by actors, production personnel, directors, and producers. IRC section 199(c)(6).

<sup>692</sup> IRC section 199(c)(4).

<sup>693</sup> For purposes of the provision, "W-2 wages" include the sum of the amounts of wages as defined in section 3401(a) and elective deferrals that the taxpayer properly reports to the Social Security Administration with respect to

## Limitation for Oil Related Qualified Production Activities Income

With respect to a taxpayer that has oil related qualified production activities income, the nine percent deduction is reduced by three percent of the least of the taxpayer's (1) oil related qualified production activities income, (2) qualified production activities income, or (3) taxable income (determined without regard to the IRC section 199 deduction).<sup>694</sup> The term "oil related qualified production activities income" means the qualified production activities income attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof (as defined in IRC section 927(a)(2)(C) prior to its repeal).<sup>695</sup>

## Independent Refiners Transportation Costs

For independent refiners in the trade or business of refining crude oil that are not major integrated oil companies (within the meaning of IRC section 167(h)(5)(B)), determined without regard to clause (iii) thereof, the provision specifies that in computing oil related qualified production activities income, only 25 percent of the properly allocable costs related to the transportation of oil are allocated to domestic production gross receipts. This has the effect of increasing oil related qualified production activities income for these taxpayers with transportation costs that are properly allocable to domestic production gross receipts.<sup>696</sup>

## Repeal of IRC Section 199

The TCJA<sup>697</sup> repealed the deduction for income attributable to domestic production activities. The repeal is effective for C corporations, and for certain rules applicable to agricultural and

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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 section 402(g)(3), amounts deferred under section 457, and, for taxable years beginning after December 31, 2005, designated Roth contributions (as defined in section 402A). See IRC section 199(b)(2). The wage limitation for qualified films includes any compensation for services performed in the U.S. by actors, production personnel, directors, and producers and is not restricted to W-2 wages. IRC section 199(b)(2)(D), effective for taxable years beginning after December 31, 2007.

<sup>694</sup> IRC section 199(d)(9). For example, assume a C corporation (the "taxpayer") has qualified production activities income of \$750,000—of which \$650,000 is oil related qualified production activities income—taxable income of \$2,000,000, and has paid sufficient domestic production wages to not be subject to the wages paid limitation for the taxable year. The taxpayer's tentative IRC section 199 deduction of \$67,500 ( $\$750,000 \times 9$  percent) is reduced by \$19,500 ( $\$650,000 \times 3$  percent), resulting in an IRC section 199 deduction of \$48,000 for the taxable year ( $\$67,500 - \$19,500$ ).

<sup>695</sup> See also Proposed Treas. Reg. section 1.199-1(f) (REG-136459-09) where the Secretary has proposed guidance on oil related qualified production activities income. Proposed Treas. Reg. section 1.199-1(f) will apply to taxable years beginning on or after the date the final regulations are published in the Federal Register.

<sup>696</sup> Continuing the above example, assume the taxpayer has properly allocable oil related transportation costs of \$100,000 that were included in determining the qualified production activities income noted above. Under this provision, the taxpayer will only allocate \$25,000 of such costs to domestic production gross receipts. Thus, the taxpayer's oil related qualified production activities income of \$650,000 and qualified production activities income of \$750,000 will each increase by \$75,000 ( $\$100,000 - \$25,000$ ), resulting in oil related qualified production activities income of \$725,000 and qualified production activities income of \$825,000. Hence, the taxpayer's tentative section 199 deduction of \$74,250 ( $\$825,000 \times 9$  percent) is reduced by \$21,750 ( $\$725,000 \times 3$  percent), resulting in an IRC section 199 deduction of \$52,500 for the taxable year ( $\$74,250 - \$21,750$ ) (compared to \$48,000 under present law).

<sup>697</sup> 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, enacted December 22, 2017.

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horticultural cooperatives provided in IRC section 199(d)(3)(A) and (B) for taxable years beginning after December 31, 2017.

New Federal Law (IRC section 199)

**Treatment of Transportation Costs of Independent Refiners (Act section 305)**

The provision clarifies, for the period in effect before the repeal of IRC section 199 under the TCJA, that IRC section 199(c)(3)(C) applies for purposes of calculating both the qualified production activities income under IRC section 199(c) and the oil related qualified production activities income under IRC section 199(d)(9).

The provision clarifies that an independent refiner may elect to apply IRC section 199(c)(3)(C) to its oil transportation costs for purposes of calculating its deduction under IRC section 199 (i.e., it is not required to apply the provision to its oil transportation costs). It is anticipated that the Secretary will issue guidance prescribing the manner in which such election shall be made.

Effective Dates

This provision shall take effect as if included in section 305 of division P of the Consolidated Appropriations Act, 2016.

California Law (R&TC sections 17201 and 17201.6)

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, neither the clarification of changes made to prior law nor the federal repeal of IRC section 199 is applicable for California purposes.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
103	Amendments Relating to Fixing America's Surface Transportation Act

Background

U.S. Passport administration is the responsibility of the Department of State.<sup>698</sup> The Secretary of State may refuse to issue or renew a passport if the applicant owes child support in excess of

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<sup>698</sup> "Passport Act of 1926," 22 U.S.C. section 211a et seq.

\$2,500 or owes certain types of federal debts, such as expenses incurred in providing assistance to an applicant to return to the U.S. Although issuance of a passport does not require a SSN or ITIN, the applicant is required under the U.S. Code to provide such number. Failure to provide an ITIN is reported by the Department of State to the IRS and may result in a \$500 fine.<sup>699</sup>

Returns and return information are confidential and may not be disclosed by the IRS, other federal employees, state employees, and certain others having access to such information except as provided in the IRC.<sup>700</sup> There are a number of exceptions to the general rule of nondisclosure that authorize disclosure in specifically identified circumstances, including disclosure of information about federal tax debts for purposes of reviewing an application for a federal loan<sup>701</sup> and for purposes of enhancing the integrity of the Medicare program.<sup>702</sup>

## Rejection or Revocation of Passport for Seriously Delinquent Taxpayers

### In General

The Secretary of State is required to deny a passport (or renewal of a passport) to a seriously delinquent taxpayer and is permitted to revoke any passport previously issued to such person. In addition to the revocation or denial of passports to delinquent taxpayers, the Secretary of State is authorized to deny an application for a passport if the applicant fails to provide a SSN or provides an incorrect or invalid SSN. With respect to an incorrect or invalid number, the inclusion of an erroneous number is a basis for rejection of the application only if the erroneous number was provided willfully, intentionally, recklessly or negligently. Exceptions to these rules are permitted for emergency or humanitarian circumstances, including the issuance of a passport for short-term use to return to the U.S. by the delinquent taxpayer.

Limited sharing of information is authorized between the Secretary of State and Secretary of the Treasury. If the Commissioner of Internal Revenue certifies to the Secretary of the Treasury the identity of persons who have seriously delinquent federal taxes, the Secretary of the Treasury or his delegate is authorized to transmit such certification to the Secretary of State for use in determining whether to issue, renew, or revoke a passport. Certification of a seriously delinquent tax debt under this provision is added to the list of actions for which the time in which the action must be performed may be postponed due to the taxpayer's service in a combat zone.<sup>703</sup> Applicants whose names are included on the certifications provided to the Secretary of State are ineligible for a passport. The Secretary of State and Secretary of the Treasury are held harmless with respect to any certification issued pursuant to this provision.

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<sup>699</sup> IRC section 6039E.

<sup>700</sup> IRC section 6103.

<sup>701</sup> IRC section 6103(l)(3).

<sup>702</sup> IRC section 6103(l)(22).

<sup>703</sup> IRC section 7508(a).

### **Applicable Only to “Seriously Delinquent Tax Debt”**

Passport rejection or revocation applies only to “seriously delinquent tax debt,” which includes any outstanding federal tax liability (including interest and any penalties) in excess of \$50,000<sup>704</sup> for which a notice of lien or a notice of levy has been filed. With respect to debts for which a notice of lien has been filed, the debt is considered seriously delinquent only if the taxpayer's administrative review rights have been exhausted or lapsed. The amount is to be adjusted for inflation annually as specified. Even if a tax debt otherwise meets the statutory threshold, it may not be considered seriously delinquent if (1) the debt is being paid in a timely manner pursuant to an installment agreement or offer-in-compromise, or (2) collection action with respect to the debt is suspended because a collection due process hearing or innocent spouse relief has been requested or is pending.

### **Taxpayer Safeguards**

Several measures ensure that the IRS corrects erroneous certifications and considers actions taken by a taxpayer after action has been initiated under this provision if such actions would have the effect of removing the debt from the category of seriously delinquent debt. These measures include limits on the authority of the Commissioner, notification requirements, standards under which the Commissioner may reverse the certification of serious delinquency, and limits on authority to delegate the certification process.

The Commissioner may only delegate the authority to provide certification of a seriously delinquent tax debt to a Deputy Commissioner for Services and Enforcement, or to a Division Commissioner (the head of an IRS operating division). Neither official may redelegate such authority.

The Commissioner must inform taxpayers regarding the procedures in three ways. First, the possible loss of a passport is added to the list of matters required to be included in notices to taxpayers of potential collection activity under IRC sections 6320 or 6331. Second, the Commissioner must provide contemporaneous notice to a taxpayer when the Commissioner sends a certification of serious delinquency to the Secretary. Finally, in instances in which the Commissioner decertifies the taxpayer's status as a delinquent taxpayer, he is required to provide notice to the taxpayer at the same time as the notice to the Secretary of the Treasury.

The decertification process provides a mechanism under which the Commissioner can correct an erroneous certification or end the certification because the debt is no longer seriously delinquent, due to certain events subsequent to the certification. If after certifying the delinquency to the Secretary, the IRS receives full payment of the seriously delinquent tax debt; the taxpayer enters into an installment agreement under IRC section 6159; the IRS accepts an offer in compromise under IRC section 7122; or a spouse files for relief from joint liability, the Commissioner must notify the Secretary that the taxpayer is not seriously delinquent. In each instance, the “decertification” is limited to the taxpayer who is the subject of one of the above actions. In the case of a claim for innocent spouse relief, the decertification is only with respect to the spouse

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<sup>704</sup> The amount is indexed to inflation annually, based on calendar year 2015.

claiming relief, not both spouses. The Commissioner must generally decertify within 30 days of the event that requires decertification.

The Commissioner must provide the notice of decertification to the Secretary of the Treasury, who must in turn promptly notify the Secretary of State of the decertification. The Secretary of State must delete the certification from the records regarding that taxpayer.

In addition, a limited judicial review of a wrongful certification (or failure to decertify) is allowed in a federal district court or the Tax Court. If the court determines that the certification is erroneous, the court may order the Secretary of the Treasury to notify the Secretary of State of the error. No other relief is authorized.

New Federal Law (IRC section 7345)

**Revocation or Denial of Passport in Case of Certain Unpaid Taxes (Act section 32101)**

The Act provides for judicial review of the Secretary's certification that an individual has a seriously delinquent tax debt, either in a U.S. District Court or in the Tax Court. The provision clarifies that the party against whom a Tax Court petition is filed is the Commissioner of the IRS. The provision also provides a tie-breaker rule clarifying that the court first acquiring jurisdiction over the action has sole jurisdiction, and corrects a cross reference.

Effective Dates

This provision shall take effect as if included in section 32101 of the Fixing America's Surface Transportation Act.

California Law (None)

California does not conform to the federal provision relating to rejection and revocation of passports for seriously delinquent taxpayers, and as a result does not conform to the judicial review of the Secretary's certification that an individual has a seriously delinquent debt.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
104	Amendments Relating to the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015



Background

**Consistent Value for Transfer and Income Tax Purposes (Act section 2004)**

The value of an asset for purposes of the estate tax generally is the fair market value at the time of death or at the alternate valuation date.<sup>705</sup> The basis of property acquired from a decedent is the fair market value of the property at the time of the decedent's death or as of an alternate valuation date, if elected by the executor.<sup>706</sup>

IRC section 1014 generally requires consistency between the estate tax value of property and basis of property acquired from a decedent. If the value of property has been finally determined for estate tax purposes, the basis in the hands of the recipient can be no greater than the value of the property as finally determined. If the value of such property has not been finally determined for estate tax purposes, then the basis in the hands of the recipient can be no greater than the value reported in a required statement. This applies to property the inclusion of which in the decedent's estate increased the liability for estate tax on such estate, but does not include any property of an estate if the liability for such tax does not exceed the credits allowable against such tax. For this purpose, the value of property has been finally determined for estate tax purposes if: (1) the value of the property is shown on an estate tax return, and the value is not contested by the Secretary before the expiration of the time for assessing estate tax; (2) in a case not described in (1), the value is specified by the Secretary and such value is not timely contested by the executor of the estate; or (3) the value is determined by a court or pursuant to a settlement agreement with the Secretary.

An executor of a decedent's estate that is required to file an estate tax return under IRC section 6018(a) is required to report to both the recipient and the IRS the value of each interest in property included in the gross estate. A person that is required to file an estate tax return under IRC section 6018(b) (returns by beneficiaries) is required to report to each other person holding a legal or beneficial interest in property to which the return relates and to the IRS the value of each interest in property included in the gross estate. The required reports must be furnished by the time prescribed by the Secretary, but in no case later than the earlier of 30 days after the return is due under IRC section 6018 or 30 days after the return is filed. In any case where reported information is adjusted after a statement has been filed, a supplemental statement must be filed not later than 30 days after such adjustment is made.

The Secretary has authority to prescribe regulations necessary to carry out these provisions, including the situation in which no estate tax return is required to be filed and when the surviving joint tenant or other recipient may have better information than the executor regarding the basis or fair market value of the property.

The penalty for failure to file correct information returns under IRC section 6721, and the penalty for failure to furnish correct payee statements under IRC section 6722, apply to the failure to file

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<sup>705</sup> IRC sections 2031 and 2032.

<sup>706</sup> IRC section 1014. See IRC section 1022 for special basis rules that apply to property acquired from an electing estate of a decedent who died during 2010.

the information returns required under this provision. Additionally, the accuracy-related penalty under IRC section 6662 applies to any inconsistent estate basis. For this purpose, there is an inconsistent estate basis if the basis of property claimed on a return exceeds the basis as determined under the above-described new rules that generally require consistency between the estate tax value of property and the basis of property acquired from a decedent under IRC section 1014.

**Mass Transit Account (MTA) Financing (Act section 2008)**

The IRC imposes an excise tax on gasoline, diesel fuel, kerosene, and certain alternative fuels at the following rates:<sup>707</sup>

Gasoline	18.3 cents per gallon
Diesel Fuel and Kerosene	24.3 cents per gallon <sup>708</sup>
Alternative Fuels	24.3 and 18.3 cents per gallon <sup>709</sup>

The IRC imposes tax on gasoline, diesel fuel, and kerosene upon removal from a refinery or on importation, unless the fuel is transferred in bulk by registered pipeline or barge to a registered terminal facility.<sup>710</sup> The imposition of tax on alternative fuels generally occurs at retail when the fuel is sold to an owner, lessee, or other operator of a motor vehicle or motorboat for use as a fuel in such motor vehicle or motorboat. Liquefied natural gas (LNG) and liquefied petroleum gas (LPG), also known as propane, are classified as alternative fuels.

The tax rate of LNG is based on its energy equivalent of a gallon of diesel (DGE) and the tax rate of LPG is based on its energy equivalent of a gallon of gasoline (GGE).

Specifically, LPG is taxed at 18.3 cents per GGE. For this purpose, “energy equivalent of a gallon of gasoline” means the amount of LPG having a BTU (British thermal unit) content of 115, 400, which is 5.75 pounds of LPG.

LNG is taxed at 24.3 cents per DGE. For this purpose, “energy equivalent of a gallon of diesel” means the amount of LNG having a BTU content of 128,700, which is 6.06 pounds of LNG.

Compressed natural gas is taxed at 18.3 cents per GGE, which is 5.66 pounds of compressed natural gas.

<sup>707</sup> These fuels are subject to an additional 0.1-cent-per-gallon excise tax to fund the Leaking Underground Storage Tank (LUST) Trust Fund (IRC sections 4041(d) and 4081(a)(2)(B)). That tax is imposed as an “add-on” to other existing taxes.

<sup>708</sup> Diesel-water emulsions are taxed at 19.7 cents per gallon (IRC section 4081(a)(2)(D)).

<sup>709</sup> The rate of tax is 24.3 cents per gallon in the case of liquefied natural gas, any liquid fuel (other than ethanol or methanol) derived from coal, and liquid hydrocarbons derived from biomass. Other alternative fuels sold or used as motor fuel are generally taxed at 18.3 cents per gallon. “Alternative fuel” also includes compressed natural gas. The rate for compressed natural gas is 18.3 cents per energy equivalent of a gallon of gasoline. See IRC section 4041(a)(2) and (3).

<sup>710</sup> IRC section 4081(a)(1).

New Federal Law (IRC section 6662 and 9503)

**Consistent Value for Transfer and Income Tax Purposes (Act section 2004)**

The Act generally requires that an heir who acquires property from a decedent (whether or not reported on an estate tax return) claim a basis no greater than the final value of the property for estate tax purposes (new IRC section 1014(f)). New IRC section 6662(b)(8) imposes a penalty in the case of an inconsistent estate basis. Under the provision, the term “inconsistent estate basis” means any portion of an underpayment attributable to the failure to comply with IRC section 1014(f). The penalty could have been viewed as applying when an heir claims a basis higher than the final estate tax value by reason of making basis adjustments relating to post-acquisition events (e.g., improvements to the property). This result is not intended. The provision modifies the definition of inconsistent estate basis to avoid this unintended result.

**Mass Transit Account (MTA) Financing (Act section 2008)**

The Act modifies the taxation of LNG and LPG from a per-gallon basis to an energy-equivalent basis. That is, the Act provides that the tax is based on the LNG DGE (24.3 cents per DGE, which is 6.06 pounds of LNG), and on the LPG GGE (18.3 cents per GGE, which is 5.75 pounds of LPG). IRC section 9503(e)(2) allocates 1.86 cents per gallon of LNG and 2.13 cents per gallon of LPG to the MTA of the Highway Trust Fund, but the Act does not specifically conform to the per-gallon basis to an energy-equivalent basis for purposes of the allocation. The provision conforms the per-gallon basis in IRC section 9503(e)(2) to the energy-equivalent basis, using DGE for LNG and GGE for LPG.

Effective Dates

The amendments made by this section shall take effect as if included in the provision of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 to which they relate.

California Law (R&TC sections 18031, 18631, and 19164)

**Consistent Value for Transfer and Income Tax Purposes (Act section 2004)**

California conforms to IRC section 1014 for purposes of determining the basis of property acquired from a decedent as of the specified date of January 1, 2015, and thus does not conform to this provision’s amendments to that section.

California generally conforms to the accuracy-related penalty<sup>711</sup> as of the specified date of January 1, 2015, and thus does not conform to the inclusion of an “inconsistent estate basis” as part of the underpayment to which the penalty applies.

With respect to the new reporting requirement that requires the executor of a decedent’s estate and the donor of a lifetime gift to report to both the recipient and the IRS the information

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<sup>711</sup> IRC section 6662.

necessary to determine the recipient's basis, current California law provides that the FTB may require a copy of such information be filed with the FTB at the time and manner as it may, by forms and instructions, require.<sup>712</sup>

**Mass Transit Account (MTA) Financing (Act section 2008)**

The FTB does not administer these types of excise taxes.

Impact on California Revenue

**Consistent Value for Transfer and Income Tax Purposes (Act section 2004)**

Baseline.

**Mass Transit Account (MTA) Financing (Act section 2008)**

The FTB does not administer these types of excise taxes.

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Section

Section Title

105

Amendments Relating to the Stephen Beck, Jr., ABLE Act of 2014

Background

**Civil Tax Penalties in General**

The IRC provides for both civil and criminal penalties to ensure complete and accurate reporting of tax liability and to discourage fraudulent attempts to defeat or evade tax. Civil and criminal penalties are applied separately. Thus, a taxpayer convicted of a criminal tax offense may be subject to both criminal and civil penalties, and a taxpayer acquitted of a criminal tax offense may nonetheless be subject to civil tax penalties. In cases involving both criminal and civil penalties, the IRS generally does not pursue both simultaneously, but delays pursuit of civil penalties until the criminal proceedings have concluded.

The majority of delinquent taxes and penalties are collected through the civil process. In determining whether a penalty applies along with an adjustment to a tax return, the examining agent is constrained not only by the applicable statutory provisions, but also by the IRS's written policy not to treat penalties as bargaining points but instead to develop facts sufficient to support

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<sup>712</sup> R&TC section 18631(c)(25) provides that the FTB may require a copy of any information return required to be filed with the Secretary of the Treasury pursuant to a provision of Part III of Subchapter A of Chapter 61 of Subtitle F (commencing with IRC section 6031) of the IRC that is added to the IRC by a public law enacted on or after January 1, 2009.

the decision to assert or not to assert a penalty.<sup>713</sup> The goal is to ensure consistency, fairness, and predictability in administration of penalties.

Civil penalties are set forth in Chapter 68 of the IRC (IRC sections 6651-6751). In general, there is a penalty for (1) fraud, (2) failure to pay or file (referred to as delinquency penalties), (3) failure to deposit estimated tax amounts, (4) negligence, substantial understatement, substantial valuation misstatements, substantial overstatement of pension liabilities, substantial estate or gift tax valuation understatement, lack of economic substance, and undisclosed foreign financial asset understatements, and understatements with respect to reportable transactions (all of the items in this list are referred to as accuracy-related penalties), (5) not filing or filing incorrect information returns, and (6) aiding and abetting understatements, taking unreasonable return positions (applied to return preparers), promoting abusive tax shelters, and failing to furnish information regarding tax shelters (referred to collectively as the preparer, promoter, and protestor penalties).

## Certain Penalties

### *a. Failure to File Tax Return or Pay Tax*

Under present law, a taxpayer who fails to file a tax return on a timely basis is subject to a penalty equal to five percent of the net amount of tax due for each month that the return is not filed, up to a maximum of five months or 25 percent.<sup>714</sup> An exception from the penalty applies if the failure is due to reasonable cause. The net amount of tax due is the excess of the amount of the tax required to be shown on the return over the amount of any tax paid on or before the due date prescribed for the payment of tax.<sup>715</sup>

For a failure to file a tax return within 60 days of the due date, a minimum penalty equal to the lesser of \$205<sup>716</sup> or 100 percent of the amount of tax required to be shown on the return is imposed. In addition the penalty amount is increased by an annual inflation adjustment.<sup>717</sup>

New Federal Law (Uncodified Section 105 affecting Section 208 of the Stephen Beck Jr., ABLE Act of 2014 (Act) affecting IRC section 6651)

### **Inflation Adjustment for Certain Civil Penalties Under the Internal Revenue Code of 1986 (Act section 208)**

The Act provides an annual inflation adjustment for the IRC section 6651(a), failure to file a tax return, fixed dollar civil tax penalty. The provision clarifies that the effective date of the annual inflation adjustments to this civil penalty generally applies to returns required to be filed, and statements required to be furnished, after December 31, 2014.

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<sup>713</sup> Policy Statement 20-1, Internal Revenue Manual, sec. 1.2.20.1.1.

<sup>714</sup> IRC section 6651(a)(1).

<sup>715</sup> IRC section 6651(b)(1).

<sup>716</sup> IRC section 6651(a).

<sup>717</sup> Section 208(a), Division B, of the Stephen Beck, Jr., ABLE Act of 2014, Public Law 113-295, amended IRC section 6651 by adding a new subsection (i) to include an inflation adjustment.

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Effective Dates

The amendments made by this section shall take effect as if included in section 208 of the Act.

California Law (R&TC section 19131)

California does not conform to IRC section 6651, relating to failure to file tax return or to pay tax, but instead has stand-alone language that parallels the federal provision. California law provides that a taxpayer who fails to file a tax return on a timely basis is subject to a penalty equal to five percent of the net amount of tax due for each month that the return is not filed, up to a maximum of five months or 25 percent.<sup>718</sup> An exception from the penalty applies if the failure is due to reasonable cause. The net amount of tax due is the excess of the amount of the tax required to be shown on the return over the amount of any tax paid on or before the due date prescribed for the payment of tax.<sup>719</sup>

In the case of a failure to file a tax return within 60 days of the due date, California law imposes a minimum penalty equal to the lesser of \$135 or 100 percent of the amount of tax required to be shown on the return.<sup>720</sup>

Impact on California Revenue

Not applicable.

*b. Tax Return Preparer's Failure to Furnish Copies to Taxpayers*

A tax return preparer is defined as any person who prepares for compensation, or who employs other people to prepare for compensation, all or a substantial portion of an income tax return or claim for refund, and certain non-income tax returns, such as estate and gift, excise, or employment tax returns.<sup>721</sup>

A tax return preparer who prepares a return or claim for refund who fails to furnish a completed copy of such return or claim to the taxpayer not later than the time such return is presented for the taxpayer's signature is assessed a penalty of \$50 per failure, unless it is shown the failure is due to reasonable cause and not willful neglect, not to exceed a maximum penalty of \$25,000 for all failures per calendar year.<sup>722</sup> In addition, the penalty amount is adjusted annually for inflation.<sup>723</sup>

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<sup>718</sup> R&TC section 19131(a).

<sup>719</sup> R&TC section 19131(c).

<sup>720</sup> R&TC section 19131(b).

<sup>721</sup> IRC section 7701(a)(36).

<sup>722</sup> IRC section 6695.

<sup>723</sup> Section 208(c), Division B, of the Stephen Beck, Jr., ABLE Act of 2014, Public Law 113-295, amended IRC section 6695 by adding a new subsection (h) to include an inflation adjustment.

New Federal Law (Uncodified Section 105 affecting Section 208 of the Act affecting IRC section 6695)

**Inflation Adjustment for Certain Civil Penalties Under the Internal Revenue Code of 1986 (Act section 208)**

The Act added an annual inflation adjustment to the penalty imposed on certain paid preparers under IRC section 6695, and clarified the operative date for the annual adjustment as applicable to returns required to be filed and statements required to be furnished after December 31, 2014.

Effective Dates

The amendments made by this section shall take effect as if included in section 208 of the Act.

California Law (R&TC section 19167)

California has modified conformity to the federal penalty for a tax return preparer's failure to furnish copies to taxpayers as of the "specified date" as of January 1, 2015.<sup>724</sup> Thus, the California penalty for any tax return preparer who prepares a return or claim for refund who fails to furnish a completed copy of such return or claim, as specified is \$50 per failure, not to exceed \$25,000 per calendar year.

California does not conform to the changes made by the Act.<sup>725</sup>

Impact on California Revenue

Not applicable.

*c. Failure to File Certain Information Returns, Registration Statements, Etc.*

If an exempt organization fails to file a required return or certain information returns, registration statements, etc., by the due date (including any extensions of time), it must pay a penalty of \$20 a day for each day the return is late. The same penalty applies if the organization does not provide all of the information required on the return or does not give the correct information. In addition, an organization that fails to file a notice within 60 days of its formation (or, if an extension is granted for reasonable cause, by the deadline established by the Secretary) is subject to a penalty equal to \$20 for each day during which the failure occurs, up to a maximum of \$5,000.<sup>726</sup>

In general, the maximum penalty for any return is the lesser of \$10,000 or 5 percent of the organization's gross receipts for the year. For an organization that has gross receipts of over \$1 million for the year, the penalty is \$100 a day up to a maximum of \$50,000.

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<sup>724</sup> R&TC sections 17024.5, 18402(a), and 23051.5.

<sup>725</sup> R&TC section 19167(b).

<sup>726</sup> Section 405(f), Division Q, of the Protecting Americans from Tax Hikes Act of 2015, Public Law 114-113, amended IRC section 6652(c) generally effective for organizations organized after the date of enactment, December 18, 2015.



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If the organization is subject to this penalty, the IRS may make a written demand to specify a date by which the return of correct information or notice must be filed. If the return or notice is not filed by that date, an individual within the organization who fails to comply may be charged a penalty of \$10 a day. The maximum penalty on all individuals for failures with respect to a return shall not exceed \$5,000. In addition, the penalty amount is adjusted annually for inflation.<sup>727</sup>

New Federal Law (Uncodified Section 105 affecting Section 208 of the Act affecting IRC section 6652(c))

### **Inflation Adjustment for Certain Civil Penalties Under the Internal Revenue Code of 1986 (Act section 208)**

The Act added an annual inflation adjustment to certain civil tax penalties imposed on exempt organizations and certain trusts under IRC section 6652(c), and clarified the operative date for the annual adjustment as applicable to returns required to be filed and statements required to be furnished after December 31, 2014.

#### Effective Date

The amendments made by this section shall take effect as if included in section 208 of the Act.

#### California Law (R&TC section 23772)

California does not conform to the federal penalty under IRC section 6652 for failure to file certain information returns, registration statements, etc. or the amendments made under the Act, but instead has stand-alone language that generally parallels the federal provision. California law provides that in the case of an exempt organization's failure to file a return, a penalty is imposed in the amount of \$5 for each month that the failure continues, not to exceed \$40, unless it is shown that the failure is due to reasonable cause.<sup>728</sup>

#### Impact on California Revenue

Not applicable.

#### *d. Failure to File Partnership Returns*

#### Background

Partnerships are generally treated as pass-through entities that do not incur an income tax at the entity level.<sup>729</sup> Income earned by a partnership, whether distributed or not, is taxed to the partners. Distributions from the partnership generally are tax-free. The items of income, gain,

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<sup>727</sup> Section 208(b), Division B, of the Stephen Beck, Jr., ABLE Act of 2014, Public Law 113-295, amended IRC section 6652(e) to include an inflation adjustment.

<sup>728</sup> R&TC section 23772(c)(1).

<sup>729</sup> An exception to this general rule is made for certain federal partnership audit adjustments under the new centralized audit procedures (Subchapter C of Chapter 63 of the IRC).

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loss, deduction or credit of a partnership generally are taken into account by a partner as allocated under the terms of the partnership agreement. If the agreement does not provide for an allocation, or the agreed allocation does not have substantial economic effect, then the items are to be allocated in accordance with the partners' interests in the partnership. To prevent double taxation of these items, a partner's basis in its interest is increased by its share of partnership income (including tax-exempt income), and is decreased by its share of any losses (including nondeductible losses).

Under present law, partnerships are required to file tax returns for each taxable year.<sup>730</sup> The partnership's tax return is required to include the names and addresses of the individuals who would be entitled to share in the taxable income if distributed and the amount of the distributive share of each individual.

In addition to applicable criminal penalties, present law imposes civil penalties for the failure to file a partnership return.<sup>731</sup> The penalty is currently \$195 times the number of partners for each month (or fraction of a month) that the failure continues, up to a maximum of 12 months. In addition, the penalty amount is adjusted annually for inflation.<sup>732</sup>

New Federal Law (Uncodified Section 105 affecting Section 208 of the Act affecting IRC section 6698)

**Inflation Adjustment for Certain Civil Penalties Under the Internal Revenue Code of 1986 (Act section 208)**

The Act added an annual inflation adjustment to the penalty imposed on certain partnerships under IRC section 6698, and clarified the operative date for the annual adjustment as applicable to returns required to be filed and statements required to be furnished after December 31, 2014.

Effective Dates

The amendments made by this section shall take effect as if included in section 208 of the Act.

California Law (R&TC section 19172)

California does not conform to federal penalty for failure to file a partnership return or the amendments made under the Act, but instead has a stand-alone penalty that parallels the federal penalty for failure to file partnership returns, except that the California penalty is \$18 per partner (rather than \$195 per partner for federal purposes) for each month (or fraction of a month) that the failure continues, up to a maximum of 12 months.<sup>733</sup>

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<sup>730</sup> IRC section 6031.

<sup>731</sup> IRC section 6698.

<sup>732</sup> Section 208(d), Division B, of the Stephen Beck, Jr., ABLE Act of 2014, Public Law 113-295, amended IRC section 6698 by adding a new subsection (e) to include an inflation adjustment.

<sup>733</sup> R&TC section 19172.

Impact on California Revenue

Not applicable.

*e. Failure to File S Corporation Returns*

Background

S corporations are generally treated as pass-through entities that do not incur an income tax at the entity level, and are not subject to corporate-level income tax on its items of income and loss. Instead, the S corporation passes through its items of income and loss to its shareholders. The shareholders take into account separately their shares of these items on their individual income tax returns.

Under present law, S corporations are required to file tax returns for each taxable year.<sup>734</sup> The S corporation's tax return is required to include the following: the names and addresses of all persons owning stock in the corporation at any time during the taxable year; the number of shares of stock owned by each shareholder at all times during the taxable year; the amount of money and other property distributed by the corporation during the taxable year to each shareholder and the date of such distribution; each shareholder's pro rata share of each item of the corporation for the taxable year; and such other information as the Secretary may require.

In addition to applicable criminal penalties, present law imposes a civil penalty for the failure to file an S corporation return.<sup>735</sup> The penalty is currently \$195 times the number of shareholders or partners for each month (or fraction of a month) that the failure continues, up to a maximum of 12 months. In addition, the penalty amount is increased by an annual inflation adjustment.<sup>736</sup>

New Federal Law (Uncodified Section 105 affecting Section 208 of the Act affecting IRC section 6699)

**Inflation Adjustment for Certain Civil Penalties Under the Internal Revenue Code of 1986 (Act section 208)**

The Act added an annual inflation adjustment to the penalty imposed on certain S corporations under IRC section 6699, and clarified the operative date for the annual adjustment as applicable to returns required to be filed and statements required to be furnished after December 31, 2014.

Effective Dates

The amendments made by this section shall take effect as if included in section 208 of the Act.

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<sup>734</sup> IRC section 6037.

<sup>735</sup> IRC section 6699.

<sup>736</sup> Section 208(e), Division B, of the Stephen Beck, Jr., ABLE Act of 2014, Public Law 113-295, amended IRC section 6699 by adding a new subsection (e) to include an inflation adjustment.

California Law (R&TC section 19172.5)

California does not conform to federal penalty for failure to file an S corporation return or the amendments made under the Act, but instead has a stand-alone penalty that parallels the federal penalty for failure to file S corporation returns, except that the California penalty is \$18 per shareholder (rather than \$195 per shareholder for federal purposes) for each month (or fraction of a month) that the failure continues, up to a maximum of 12 months.<sup>737</sup>

Impact on California Revenue.

Not applicable.

*f. Failure to File Correct Information Returns & Failure to File Correct Payee Statement*

Background

Failure to comply with the information reporting requirements of the IRC results in penalties, which may include a penalty for failure to file the information return,<sup>738</sup> failure to furnish payee statements,<sup>739</sup> or failure to comply with other various reporting requirements.<sup>740</sup> No penalty is imposed if the failure is due to reasonable cause.<sup>741</sup>

Any person who is required to file an information return, or furnish a payee statement, but who fails to do so on or before the prescribed due date, is subject to a penalty that varies based on when, if at all, the information return is filed. Both the failure-to-file and failure-to-furnish penalties are adjusted annually for inflation.<sup>742</sup>

If a person files an information return after the prescribed filing date but on or before the date that is 30 days after the prescribed filing date, the amount of the penalty is \$50 per return (“first-tier penalty”), with a maximum penalty of \$500,000 per calendar year. If a person files an information return after the date that is 30 days after the prescribed filing date but on or before August 1, the amount of the penalty is \$100 per return (“second-tier penalty”), with a maximum penalty of \$1,500,000 per calendar year. If an information return is not filed on or before August 1 of any year, the amount of the penalty is \$250 per return (“third-tier penalty”), with a maximum penalty of \$3,000,000 per calendar year. If a failure to file is due to intentional disregard of a filing requirement, the minimum penalty for each failure is \$250, with no calendar-year limit.

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<sup>737</sup> R&TC section 19172.5.

<sup>738</sup> IRC section 6721.

<sup>739</sup> IRC section 6722.

<sup>740</sup> IRC section 6723. The penalty for failure to comply timely with a specified information reporting requirement is \$50 per failure, not to exceed \$100,000 per calendar year.

<sup>741</sup> IRC section 6724.

<sup>742</sup> Section 208(f), Division B, of the Stephen Beck, Jr., ABLE Act of 2014, Public Law 113-295, amended IRC section 6721 by adding a new subsection (f) to include an inflation adjustment to the applicable penalties under section 6721; and Section 208(g), Division B, of the Stephen Beck, Jr., ABLE Act of 2014, Public Law 113-295, amended IRC section 6722(f) to include an inflation adjustment to the applicable penalties under section 6722.

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Lower maximum levels for this failure-to-file-correct-information-return penalty apply to small businesses. Small businesses are defined as firms having average annual gross receipts for the most recent three taxable years that do not exceed \$5 million. The maximum penalties for small businesses are: \$175,000 (instead of \$250,000) if the failures are corrected on or before 30 days after the prescribed filing date; \$500,000 (instead of \$1,500,000) if the failures are corrected on or before August 1; and \$1,000,000 (instead of \$3,000,000) if the failures are not corrected on or before August 1.

Any small business that is required to furnish a payee statement and 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 payee statement is furnished, similar to the penalty for filing an information return discussed above. A first-tier penalty is \$30, subject to a maximum of \$250,000, a second-tier penalty is \$60 per statement, up to \$500,000, and a third-tier penalty is \$100, up to a maximum of \$1,500,000.

In cases in which the failure to file an information return or to furnish the correct payee statement is due to intentional disregard, the minimum penalty for each failure is \$500, with no calendar-year limit. No distinction is made between small businesses and other persons required to report in such cases. In addition, the penalty amounts are increased by an annual inflation adjustment.

New Federal Law (Uncodified Section 105 affecting Section 208 of the Act affecting IRC sections 6721 and 6722)

### **Inflation Adjustment for Certain Civil Penalties Under the Internal Revenue Code of 1986 (Act section 208)**

The Act added an annual inflation adjustment to the penalty imposed on certain civil penalties under IRC sections 6721 and 6722, and clarifies the operative date for the annual adjustment as applicable to returns required to be filed and statements required to be furnished after December 31, 2014.

#### Effective Dates

The amendments made by this section shall take effect as if included in section 208 of the Act.

#### California Law (R&TC section 19183)

California generally conforms to IRC sections 6721 and 6722 penalties for failure to file correct information returns and payee statements as of the “specified date” of January 1, 2015, with amendments applicable to information returns required to be filed on or after January 1, 2016.<sup>743</sup> Unlike the federal penalties that are adjusted annually for inflation, the California penalties for the failure to file information returns and the failure to furnish payee statements penalties are adjusted to account for inflation every five years.)<sup>744</sup> Thus, California law does not conform to the amendments made by the Act.

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<sup>743</sup> R&TC section 19183(g).

<sup>744</sup> R&TC sections 19183(a)(3) and (b)(3).

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
106	Amendment Relating to the American Taxpayer Relief Act of 2012

Background

The IRC defines the term “deficiency” as the amount of tax shown on the taxpayer’s return, plus amounts previously assessed (or collected without assessment), less any rebates (*i.e.*, an abatement, credit, refund, or other repayment).<sup>745</sup> The IRC also provides rules for the application of tax, credits and rebates, including definitions of these terms and references to various federal code sections.<sup>746</sup> The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA),<sup>747</sup> an act to provide for reconciliation pursuant to section 104 of the concurrent resolution on the budget for fiscal year 2002, made significant changes to federal income tax rates, estate and gift tax exclusions, qualified and retirement plan provisions, and the extension of various credits. These amendments were set to expire at the end of 2010. The American Taxpayer Relief Act (ATRA) of 2012<sup>748</sup> extended the provisions of EGTRRA to provide for the permanent extension of certain individual, estate and gift tax provisions, and other expiring provisions.

New Federal Law (Uncodified Section 104 relating to Section 106 of the Act affecting IRC section 6211(b))

The provision conforms a reference in IRC section 6211(b)(4)(A), relating to the definition of a deficiency, to the provision of the AOTC as renumbered by the Act.

Effective Dates

The amendment made by this section shall take effect as if included in section 104 of the ATRA of 2012.

California Law (R&TC section 19043)

California does not conform to IRC section 6211, relating to the definition of a deficiency or the amendments made under the Act, but instead has stand-alone language that parallels the federal provision. California law defines “deficiency” as the amount of tax imposed by the law that exceeds the amount of tax shown on the taxpayer’s original or amended return, plus any amount

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<sup>745</sup> IRC section 6211(a).

<sup>746</sup> IRC section 6211(b).

<sup>747</sup> Public Law 107-16.

<sup>748</sup> Public Law 112-240.

previously assessed (or collected without assessment) as a deficiency, less any rebates (*i.e.*, an abatement, credit, refund, or other repayment).<sup>749</sup>

Impact on California Revenue

Not applicable.

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Section

Section Title

109

Amendments Relating to the American Jobs Creation Act of 2004

Background

**Treatment of Certain Trusts as Shareholder of S Corporation (Act section 233)**

An individual retirement account (IRA) is a trust or account established for the exclusive benefit of an individual and his or her beneficiaries. There are two general types of IRAs: traditional IRAs, to which both deductible and nondeductible contributions may be made, and Roth IRAs, contributions to which are not deductible. Amounts held in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income; distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings. A qualified distribution is a distribution that (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) is made after attainment of age 59 1/2, on account of death or disability, or is made for first-time homebuyer expenses of up to \$10,000.

Other than certain shareholders of a bank, an IRA cannot be a shareholder of an S corporation. An IRA (including a Roth IRA) is allowed to be a shareholder of a bank that is an S corporation, but only to the extent of bank stock held by the IRA on October 22, 2004. Rules treating S corporation stock held by a qualified retirement plan (other than an employee stock ownership plan) or a charity as an interest in an unrelated trade or business apply to an IRA holding S corporation stock of a bank.

Certain transactions are prohibited between an IRA and the individual for whose benefit the IRA is established, including a sale of property by the IRA to the individual. If a prohibited transaction occurs between an IRA and the IRA beneficiary, the account ceases to be an IRA, and an amount equal to the fair market value of the assets held in the IRA is deemed distributed to the beneficiary.

There is also an exemption from prohibited transaction treatment for the sale by an IRA to an IRA beneficiary of bank stock held by the IRA on October 22, 2004. A sale is not a prohibited transaction if: (1) the sale is pursuant to an S corporation election by the bank; (2) the sale is for

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<sup>749</sup> R&TC section 19043(a).



fair market value (as established by an independent appraiser) and is on terms at least as favorable to the IRA as the terms would be on a sale to an unrelated party; (3) the IRA incurs no commissions, costs, or other expenses in connection with the sale; and (4) the stock is sold in a single transaction for cash not later than 120 days after the S corporation election is made.

### **Rural Electric Cooperatives (Act section 319)**

An entity must be operated on a cooperative basis in order to be treated as a cooperative for federal income tax purposes. Although not defined by statute or regulation, the two principal criteria for determining whether an entity is operating on a cooperative basis are: (1) ownership of the cooperative by persons who patronize the cooperative; and (2) return of earnings to patrons in proportion to their patronage. The IRS requires that cooperatives must operate under the following principles: (1) subordination of capital in control over the cooperative undertaking and in ownership of the financial benefits from ownership; (2) democratic control by the members of the cooperative; (3) vesting in and allocation among the members of all excess of operating revenues over the expenses incurred to generate revenues in proportion to their participation in the cooperative (patronage); and (4) operation at cost (not operating for profit or below cost).<sup>750</sup>

In general, cooperative members are those who participate in the management of the cooperative and who share in patronage capital. As described below, income from the sale of electric energy by an electric cooperative may be member or non-member income to the cooperative, depending on the membership status of the purchaser. A municipal corporation may be a member of a cooperative.

For federal income tax purposes, a cooperative generally computes its income as if it were a taxable corporation, with one exception – the cooperative may exclude from its taxable income distributions of patronage dividends. In general, patronage dividends are the profits of the cooperative that are rebated to its patrons pursuant to a pre-existing obligation of the cooperative to do so. The rebate must be made in some equitable fashion on the basis of the quantity or value of business done with the cooperative.

Except for tax-exempt farmers' cooperatives, cooperatives that are subject to the cooperative tax rules of Subchapter T of the Code (Sec. 1381, et seq.) are permitted a deduction for patronage dividends from their taxable income only to the extent of net income that is derived from transactions with patrons who are members of the cooperative (Sec. 1382). The availability of such deductions from taxable income has the effect of allowing the cooperative to be treated like a conduit with respect to profits derived from transactions with patrons who are members of the cooperative.

Cooperatives that qualify as tax-exempt farmers' cooperatives are permitted to exclude patronage dividends from their taxable income to the extent of all net income, including net income that is derived from transactions with patrons who are not members of the cooperative, provided the value of transactions with patrons who are not members of the cooperative does not exceed the value of transactions with patrons who are members of the cooperative (Sec. 521).

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<sup>750</sup> Announcement 96-24, "Proposed Examination Guidelines Regarding Rural Electric Cooperatives," 1996-16 I.R.B. 35.

*Taxation of electric cooperatives exempt from Subchapter T*

In general, the cooperative tax rules of Subchapter T apply to any corporation operating on a cooperative basis (except mutual savings banks, insurance companies, other tax-exempt organizations, and certain utilities), including tax-exempt farmers' cooperatives (described in Sec. 521(b)). However, Subchapter T does not apply to an organization that is "engaged in furnishing electric energy, or providing telephone service, to persons in rural areas" (Sec. 1381(a)(2)(C)). Instead, electric cooperatives are taxed under rules that were generally applicable to cooperatives prior to the enactment of Subchapter T in 1962. Under these rules, an electric cooperative can exclude patronage dividends from taxable income to the extent of all net income of the cooperative, including net income derived from transactions with patrons who are not members of the cooperative.<sup>751</sup>

*Tax exemption of rural electric cooperatives*

Section 501(c)(12) provides an income tax exemption for rural electric cooperatives if at least 85 percent of the cooperative's income consists of amounts collected from members for the sole purpose of meeting losses and expenses of providing service to its members. The IRS takes the position that rural electric cooperatives also must comply with the fundamental cooperative principles described above in order to qualify for tax exemption under Section 501(c)(12).<sup>752</sup> The 85-percent test is determined without taking into account any income from qualified pole rentals and cancellation of indebtedness income from the prepayment of a loan under Sections 306A, 306B, or 311 of the Rural Electrification Act of 1936 (as in effect on January 1, 1987). The exclusion for cancellation of indebtedness income applies to such income arising in 1987, 1988, or 1989 on debt that either originated with, or is guaranteed by, the federal government.

The receipt by a rural electric cooperative of contributions in aid of construction and connection charges is taken into account for purposes of applying the 85-percent test.

Income received or accrued by a rural electric cooperative (other than income received or accrued directly or indirectly from a member of the cooperative) or from the sale of electric energy transmission services or ancillary services on a nondiscriminatory open access basis under an open access transmission tariff approved or accepted by Federal Energy Regulatory Commission (FERC) or under an independent transmission provider agreement approved or accepted by FERC (including an agreement providing for the transfer of control—but not ownership—of transmission facilities) is excluded in determining whether a rural electric cooperative satisfies the 85-percent test for tax exemption under Section 501(c)(12).

Rural electric cooperatives generally are subject to the tax on unrelated trade or business income under Section 511.

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<sup>751</sup> See Rev. Rul. 83-135, 1983-2 C.B. 149.

<sup>752</sup> Rev. Rul. 72-36, 1972-1 C.B. 151. This Revenue Ruling has been modified by Rev. Rul. 81-109, 1981-1 CB 347.

New Federal Law (IRC sections 501 and 1361)

**Treatment of Certain Trusts as Shareholder of S corporation (Act section 233)**

The provision clarifies that only the individual for whose benefit the trust is created is treated as “the shareholder.”

**Rural Electric Cooperatives (Act section 319)**

IRC section 501(c)(12) provides an income tax exemption for rural electric cooperatives if at least 85 percent of the cooperative's income consists of amounts collected from members for the sole purpose of meeting losses and expenses of providing service to its members. The Energy Policy Act of 2005 made permanent a rule to exclude from the 85-percent test income from transactions related to open access transmission if approved by the FERC. FERC regulates transmission lines in all states except Alaska, Hawaii, and most of Texas. Because of an oversight, only transmission systems in Texas received the treatment accorded to FERC-regulated electric cooperatives. Electric cooperatives in Alaska are regulated by the Regulatory Commission of Alaska (RCA). Regulated utilities in Alaska with an RCA approved open access transmission tariff modeled after FERC should have received the same tax treatment as their similarly situated counterparts in the other states. The provision clarifies that that such utilities in Alaska and Hawaii are treated the same as those in Texas for purposes of the exclusion from the 85-percent test.

Effective Dates

The amendments made by this section shall take effect as if included in section 319 of the American Jobs Creation Act of 2004.

California Law (R&TC Sections 17087.5, 23800, 23801, 24406, 24406.5, and 24406.6)

**Treatment of Certain Trusts as Shareholder of S Corporation (Act section 233)**

Beginning in 2002, California law provides that all corporations with a valid federal S corporation election are also S corporations under California law. This equates to California automatically conforming to any federal law change affecting the qualification requirements of an S corporation. Thus, the federal clarification related to treatment of an individual for whose benefit the trust is created as “the shareholder” is a qualification issue. California is already in conformity to the above federal change.

**Rural Electric Cooperatives (Act section 319)**

California does not conform to the tax exemption in IRC Section 501(c)(12) for rural electric cooperatives or the amendments made under the Act. Instead, California has specific rules relating to special deductions allowed to cooperatives.

Cooperatives whose income is derived from the sale of tangible personal property other than water, agricultural products or food sold at wholesale are allowed to deduct only patronage

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refunds paid or accrued that meet all of the following conditions:

- Are made in accordance with a pre-existing obligation created by the association’s by-laws or other written instrument.
- Are made from earnings attributable to business done by the association with the patrons to whom the patronage refunds are made.
- Are allocated ratably according to the patronage with notification to the patrons on or before the due date for filing the franchise tax return (including extensions).

Regarding patronage refunds of gas producers, each cooperative corporation has to certify its eligibility for the deduction at the time and in the manner prescribed by the FTB.

To the extent provided in a cooperative’s organizational documents (articles of incorporation, bylaws or other contract with patrons), dividends on capital stock will not reduce patronage income or prevent the cooperative from being treated as operating on a cooperative basis.

Impact on California Revenue

**Treatment of Certain Trusts as Shareholder of S Corporation (Act section 233)**

Baseline.

**Rural Electric Cooperatives (Act section 319)**

Not Applicable.

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**Division U, Title II—Technical Corrections Related to Partnership Audit Rules**

<u>Section</u>	<u>Section Title</u>
201	Scope of Adjustments Subject to Partnership Audit Rules

Background

**Repeal of TEFRA and Electing Large Partnership Rules**

Generally for returns filed for partnership taxable years beginning after 2017,<sup>753</sup> the tax reporting provisions and voluntary centralized audit procedures for electing large partnerships, as well as the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) partnership audit and adjustment rules, are repealed. In place of the repealed procedures, a centralized system for audit, adjustment, assessment, and collection of tax applies to all partnerships, except those eligible partnerships that have filed a valid election out. Electing out of the centralized system leaves

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<sup>753</sup> Balanced Budget Act of 2015 (BBA of 2015), Public Law 114-74, enacted November 2, 2015.

applicable the prior-law rules for deficiency proceedings. The centralized system is located in subchapter C of chapter 63 of the IRC.

## **In General**

### *Determination at Partnership Level*

Under the centralized system, the audit of a partnership takes place at the partnership level. Any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year, and any partner's distributive share thereof, generally are determined at the partnership level.<sup>754</sup> Any tax attributable to these items generally is assessed and collected at the partnership level. The applicability of any penalty, addition to tax, or additional amount that relates to an adjustment of any item of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year or to any partner's distributive share thereof is determined at the partnership level. Unlike prior law, distinctions between partnership items and affected items are no longer made. An underpayment of tax determined as a result of an examination of a taxable year is imputed to the year during which the adjustment is finally determined, and generally is assessed against and collected from the partnership with respect to that year rather than the reviewed year.

Under the centralized system, a partnership may seek modification of the imputed underpayment amount by providing the Secretary with specified information about the tax status of partners and about the nature and amount of items of income or gain, by means of reviewed-year partners filing amended returns with payment, or on the basis of other factors in regulations or guidance. A partnership may elect an alternative to partnership payment of the imputed underpayment in which each reviewed-year partner is furnished a statement of the partner's share of the adjustments (similar to Schedule K-1) and each such reviewed-year partner increases its tax for the year the statement is furnished. A partnership may file an administrative adjustment request. Rules are provided relating to statutes of limitation and other applicable time periods, interest and penalties, judicial review, and other aspects of the centralized system under the provision.

## **Election Out**

The centralized system is applicable to any partnership unless it meets eligibility requirements and has made a valid election out for a taxable year.<sup>755</sup>

### *100 or Fewer Statements*

A partnership may elect out of the centralized system (and it and its partners are governed by the prior-law deficiency proceedings) for a partnership taxable year if it meets eligibility requirements. One of the eligibility requirements is that for the taxable year, the partnership is required to furnish 100 or fewer statements under IRC section 6031(b) (Schedules K-1) with respect to its partners.

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<sup>754</sup> IRC section 6221(a).

<sup>755</sup> IRC section 6221(b).

A further eligibility requirement for a partnership to make the election is that each partner is either an individual, a deceased partner's estate, a C corporation, a foreign entity that would be required to be treated as a C corporation if it were a domestic entity, or an S corporation (provided special rules are met). A partnership with a foreign entity as a partner can meet this eligibility requirement if, under the rules of IRC section 7701, the foreign entity would be taxable as a C corporation if it were domestic; that is, the foreign entity has elected to be, or is, treated as a *per se* corporation under the check-the-box regulatory rules under IRC section 7701.<sup>756</sup>

A C corporation partner that is a regulated investment company (RIC) or a real estate investment trust (REIT) does not prevent the partnership from being able to elect out, provided the applicable requirements are met.

#### *Time and Manner of Election Out*

The election out must be made with a timely-filed return of the partnership taxable year to which the election out relates and is valid only for that year. The election out must include the name and taxpayer identification number of each partner of the partnership in the manner prescribed by the Secretary. The partnership must notify each of its partners of the election out in the manner prescribed by the Secretary.

#### **Partnership Adjustments**

##### *Partnership Adjustments by the Secretary*

The centralized system provides that any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year and any partner's distributive share thereof, are determined at the partnership level. Any tax attributable to these items is assessed and generally is collected at the partnership level as an imputed underpayment paid by the partnership.

##### *Reviewed Year and Adjustment Year*

For purposes of the centralized system, the reviewed year means the partnership taxable year to which the item being adjusted relates. For example, in an examination by the Secretary of a partnership's taxable year 2018, 2018 is the reviewed year.<sup>757</sup>

The adjustment year means: (1) in the case of an adjustment pursuant to the decision of a court (under the centralized system's judicial review provisions), the partnership taxable year in which the decision becomes final; (2) in the case of an administrative adjustment request, the partnership taxable year in which the administrative adjustment request is made; or (3) in any other case, the partnership taxable year in which the notice of final partnership adjustment is mailed.<sup>758</sup> For example, in the case of adjustments with respect to partnership taxable year 2018 resulting in an imputed underpayment assessed in 2020 that the partnership then litigates in Tax

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<sup>756</sup> See Treas. Reg. section 301.7701-2 and -3.

<sup>757</sup> IRC section 6225(d)(1).

<sup>758</sup> IRC section 6225(d)(2).

Court, the decision of which is not appealed and becomes final in 2021, the adjustment year is 2021.

## **Procedural Rules**

### *In General*

The new centralized system provides rules governing notices, time limitations, restrictions on assessment, and the imposition of interest and penalties in the context of a partnership adjustment. The provisions include specific grants of regulatory authority to address the identification of foreign partners, the manner of notifying partners of an election out of centralized procedures, the manner in which a partnership representative is selected, and the extent to which the new centralized system may be applied before the generally applicable operative date.

### *Notice of Proceedings and Adjustments*

The centralized system contemplates three types of principal notifications by the Secretary to the partnership and the partnership representative in the course of an administrative proceeding with respect to that partnership. The notifications also apply to any proceeding with respect to an administrative adjustment request filed by a partnership. These notices are (1) notice of any administrative proceeding initiated at the partnership level; (2) notice of a proposed partnership adjustment resulting from the proceeding; and (3) notice of any final partnership adjustment resulting from the proceeding. Such notices are sufficient if mailed to the last known address of the partnership representative or the partnership, even if the partnership has terminated its existence.

A notice of proposed adjustments informs the partnership of any adjustments tentatively determined by the Secretary and the amount of any imputed underpayment resulting from such adjustments. The issuance of a notice of proposed partnership adjustment begins the running of a period of 270 days during which all information required by the Secretary in support of a request for modification must be supplied. During that same period, the Secretary may not issue a notice of final partnership adjustment. The Secretary is required to establish procedures and timeframes for the modification process in published guidance, which may include conditions under which extensions of time in which to submit final documentation of a modification request may be permitted by the Secretary.

With the issuance of a notice of final partnership adjustment to the partnership, a 90-day period begins during which the partnership may seek judicial review of the partnership adjustment. The issuance of a notice of final partnership adjustment also marks the beginning of the 45-day period in which the partnership may elect the alternative payment procedures. Further notices of adjustment or assessments of tax against the partnership with respect to the partnership taxable year that is the subject of the notice of final partnership adjustment are prohibited during the period in which judicial review may be sought or during which a judicial proceeding is pending (absent a showing of fraud, malfeasance, or misrepresentation of a material fact).



Any notice of partnership adjustment may be rescinded by the Secretary, if the partnership consents. A rescinded notice is a nullity, and does not confer a right to seek judicial review, nor bar issuance of further notices.

## **Definitions and Special Rules**

### *Partnership*

The term partnership means any partnership required to file a return under IRC section 6031(a). This includes any partnership described in IRC section 761 that is required to file a return.

### *Partnership Adjustment*

The term partnership adjustment means any adjustment in the amount of any item of income, gain, loss, deduction, or credit of a partnership, or any partner's distributive share thereof.

### *Return Due Date*

The term return due date means, with respect to the taxable year, the date prescribed for filing the partnership return for such taxable year (determined without regard to extensions).

### *Payments Nondeductible*

No deduction is allowed under the federal income tax for any payment required to be made by a partnership under the centralized system of partnership audit, assessment, and collection. Under the centralized system, the flow-through nature of the partnership under subchapter K of the IRC is unchanged, but the partnership is treated as a point of collection of underpayments that would otherwise be the partners' responsibility. The return filed by the partnership, though it is an information return, is treated as if it were a tax return where necessary to implement examination, assessment, and collection of the tax due and any penalties, additions to tax, and interest.

A basis adjustment (reduction) to a partner's basis in its partnership interest is made to reflect the partnership's nondeductible payment of the tax. Specifically, present-law IRC section 705(a)(2)(B) applies, providing that the adjusted basis of a partner's interest in a partnership is the basis of the interest determined under applicable rules relating to contributions and transfers, and decreased (but not below zero) by partnership expenditures that are not deductible in computing its taxable income and not properly chargeable to its capital account. Concomitantly, the partnership's total adjusted basis in its assets is reduced by the cash payment of the tax.

Thus, parallel basis reductions are made to outside and inside basis to reflect the partnership's payment of the tax. Partners, former partners, and the partnership may have entered into indemnification agreements under the partnership agreement with respect to the risk of tax liability of former or new partners being borne economically by new or former partners, respectively. Because the payment of tax by a partnership under the centralized system is nondeductible, payments under an indemnification or similar agreement with respect to or arising from the tax are nondeductible.

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*Partnerships Having Principal Place of Business Outside the United States*

For purposes of judicial review following a notice of final partnership adjustment, a principal place of business located outside the U.S. is treated as located in the District of Columbia.

*Suspension of Period of Limitations on Making Adjustment, Assessment or Collection*

The provision includes a rule similar to the prior-law rule to conform the automatic stay of the Bankruptcy Code (Title 11) with the limitations period applicable under the centralized system for partnership adjustments. Any statute of limitations period provided under the centralized system on making a partnership adjustment, or on assessment or collection of an imputed underpayment, is suspended during the period the Secretary is prohibited by reason of the Title 11 case from making the adjustment, assessment, or collection. For adjustment or assessment, the relevant statute of limitations is extended for 60 days thereafter. For collection, the relevant statute of limitations is extended for six months thereafter.

In a case under Title 11, the 90-day period to petition for judicial review after the mailing of the notice of final partnership adjustment is suspended during the period the partnership is prohibited by reason of the Title 11 case from filing such a petition for judicial review, and for 60 days thereafter.

*Treatment Where Partnership Ceases to Exist*

If a partnership ceases to exist before a partnership adjustment under the centralized system is made, the adjustment is taken into account by the former partners of the partnership, under regulations provided by the Secretary. Whether a partnership ceases to exist for this purpose is determined without regard to whether there is a technical termination of the partnership within the meaning of IRC section 708(b)(1)(B). The successor partnership in a technical termination succeeds to the adjustment or imputed underpayment, absent regulations to the contrary. A partnership that terminates within the meaning of IRC section 708(b)(1)(A) is treated as ceasing to exist. In addition, a partnership also may be treated as ceasing to exist in other circumstances or based on other factors, under regulations provided by the Secretary. For example, for the purpose of determining whether a partnership ceases to exist under new IRC section 6241(7), a partnership that has no significant income, revenue, assets, or activities at the time the partnership adjustment takes effect may be treated as having ceased to exist.

*Extension to Entities Filing Partnership Return*

If a partnership return (Form 1065) is filed by an entity for a taxable year but it is determined that the entity is not a partnership (or that there is no entity) for the year, then, to the extent provided in regulations, the provisions of this subchapter are extended in respect of that year to the entity and its items of income, gain, loss, deduction, and credit, and to persons holding an interest in the entity.

For example, assume two taxpayers purport to create a partnership for taxable year 2018, and a Form 1065 is filed for that year. The partnership is the subject of an audit under the centralized system for 2018, and pursuant to the provisions for judicial review, the partnership is determined

by a court not to exist as a partnership. Nevertheless, the rules of the centralized system apply to the items of income, gain, loss, deduction and credit, and to the two taxpayers, in respect of 2018. An imputed underpayment may be collected from the purported partnership in the adjustment year pursuant to new IRC section 6225.

Alternatively, the purported partnership representative may elect (at the time and in the manner prescribed by the Secretary) under new IRC section 6226 to issue statements to the two taxpayers, which purported to hold partnership interests for the reviewed year. To the extent of the adjustments, each of the two taxpayer's tax may be increased for the taxpayer's taxable year that includes the date of the statement. In this situation, the amount of the increase for each taxpayer is the amount by which the taxpayer's tax would increase if the taxpayer's share of the adjustment amounts were included for the taxpayer's taxable year that includes the end of the reviewed year, plus the amount by which the tax would increase by reason of adjustment to tax attributes in years after that year of the taxpayer and before the year of the date of the statement.

#### New Federal Law (IRC section 6241)

The provision clarifies the scope of the partnership audit rules by eliminating references to adjustments to partnership income, gain, loss, deduction, or credit, and instead referring to partnership-related items, defined as any item or amount with respect to the partnership that is relevant in determining the income tax liability of any person, without regard to whether the item or amount appears on the partnership's return and including an imputed underpayment and an item or amount relating to any transaction with, basis in, or liability of, the partnership. Thus, these partnership audit rules are not narrower than the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) partnership audit rules, but rather, are intended to have a scope sufficient to address those items described as partnership items, affected items, and computational items in the TEFRA context in Treas. Reg. sections 301.6231(a)(3), 301.6231(a)(5), and 301.6231(a)(6), as well as any other items meeting the statutory definition of a partnership-related item.

For example, because a partnership-related item includes an item or amount relating to any transaction with the partnership, an item or amount relating to a partner's transaction with a partnership other than in his capacity as a member of the partnership (which is considered as occurring between the partnership and one who is not a partner under IRC section 707) is a partnership-related item. As another example, because a partnership-related item includes an item or amount relating to basis in the partnership, an item or amount relating to the determination of the adjusted basis of a partner's interest in the partnership or relating to the basis of the partnership in partnership property is a partnership-related item. As a further example, because a partnership-related item includes an item or amount relating to liability of the partnership, an item or amount relating to the determination of partnership liabilities or to the effect on a partner of a decrease or increase in a partner's share of partnership liabilities is a partnership-related item.

The provision clarifies that the partnership audit rules do not apply to taxes imposed, or to amounts required to be deducted or withheld, under IRC chapters 2 (tax on self-employment income) or 2A (tax on net investment income), 3 (withholding tax on nonresident alien individuals or foreign corporations), or 4 (withholding tax for certain foreign accounts), except as otherwise

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specifically provided. However, any partnership adjustment determined under the income tax is taken into account for purposes of determining and assessing tax under these chapters of the IRC to the extent that the partnership adjustment is relevant to the determination. Further, a timing rule applies in the case of chapters 3 and 4.

For example, if a partnership adjustment results in a change in the amount of income of an individual from a partnership, the change is reflected as required under the rules of chapter 2 in the calculation of the individual's net earnings from self-employment with respect to the partnership, and the chapter 2 tax may be collected through a process that is outside the partnership audit rules.

The period for assessing any tax under chapter 2 or 2A that is attributable to a partnership adjustment does not expire before the date that is (1) one year after a decision of a court in a proceeding brought under IRC section 6234 becomes final, or (2) 90 days after the date on which the notice of final partnership adjustment is mailed under IRC section 6231, in any other case.

The provision applies a specific timing rule in the case of any tax imposed, including any amount that is required to be deducted or withheld, under chapter 3 (withholding tax on nonresident alien individuals or foreign corporations) or 4 (withholding tax for certain foreign accounts). In these cases, the tax is determined with respect to the reviewed year, and the tax is imposed with respect to the adjustment year; similarly, the amount required to be deducted or withheld is deducted or withheld with respect to the adjustment year. The reviewed year and the adjustment year are defined in IRC section 6225(d).

For example, assume that a partnership has foreign partners, and that following an audit of the partnership, an adjustment is made to the amount of the partnership's effectively connected taxable income. The adjustment results in an increase of \$100x of such income that is allocable to foreign partners with respect to the reviewed year. Pursuant to IRC section 1446, assume that the amount of withholding tax that the partnership is required to pay with respect to this income allocable to the foreign partners is \$35x. The \$35x is required to be paid by the partnership with respect to the adjustment year (as defined in IRC section 6225(d)(2)).

As a further example, assume that a partnership, with foreign partners is not the audited partnership, but rather, is an upper tier partner of an audited partnership that has elected to push out under IRC section 6226. Partnership has received a statement pursuant to IRC section 6226. The amount of withholding tax partnership is required to pay is determined with respect to the reviewed year of the audited partnership, as it affects the relevant taxable year of partnership. The amount of withholding tax is required to be paid by partnership for the partnership taxable year that is the adjustment year, in this case, the adjustment year of the audited partnership (IRC section 6225(d)). The due date for partnership's payment of the withholding tax is no later than the due date (including allowable extensions) for the return for the adjustment year of the audited partnership.

In determining the amount of any deficiency, adjustments to partnership-related items are made only as provided under the partnership audit rules (Subchapter C of Chapter 63 of the IRC), except to the extent otherwise provided. Conforming references to partnership-related items are made in

several other provisions, including the provision relating to the scope of judicial review of a partnership adjustment (IRC section 6234(c)).

Thus, the court has jurisdiction to determine all partnership-related items of the partnership for the partnership taxable year to which the notice of final partnership adjustment relates, the proper allocation of such items among the partners, and the applicability of any penalty, addition to tax, or additional amount for which the partnership may be liable under subchapter C of chapter 63 of the IRC. For example, because partnership-related items include items or amounts with respect to (1) IRC section 707 transactions, (2) liabilities of the partnership and the partners' shares of the liabilities, and (3) the basis of a partnership interest or of partnership property, determination of these items or amounts is within the scope of judicial review.

#### Effective Dates

The amendments made by this section shall take effect as if included in section 1101 of the Bipartisan Budget Act of 2015.

#### California Law (R&TC sections 18622 and 18622.5)

For purposes of reporting federal audit adjustments and administrative adjustment requests to the state, California has modified conformity<sup>759</sup>, under the Administration of Franchise and Income Tax Laws (AFITL), to the new federal centralized system for audit, adjustment and assessment of tax for partnerships as in effect January 1, 2018.

California does not conform to the federal definitions and special rules relating to partnership audit adjustments under the new centralized system for audit, the adjustment and assessment of tax for partnerships,<sup>760</sup> or the amendments made under the Act clarifying those definitions and rules. California has stand-alone provisions for the reporting of federal partnership audit adjustments and the assessment of tax on partnerships and partners based on federal partnership adjustments under the new centralized system.<sup>761</sup>

#### Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
202	Determination of Imputed Underpayments

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<sup>759</sup> R&TC section 18622.5.

<sup>760</sup> IRC section 6241.

<sup>761</sup> R&TC section 18622 and 18622.5.

## Background

### **Repeal of TEFRA and Electing Large Partnership Rules**

Generally for returns filed for partnership taxable years beginning after 2017,<sup>762</sup> the tax reporting provisions and voluntary centralized audit procedures for electing large partnerships, as well as the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) partnership audit and adjustment rules, are repealed. In place of the repealed procedures, a centralized system for audit, adjustment, assessment, and collection of tax applies to all partnerships, except those eligible partnerships that have filed a valid election out. Electing out of the centralized system leaves applicable the prior-law rules for deficiency proceedings. The centralized system is located in subchapter C of chapter 63 of the IRC.

### **In General**

#### *Determination at Partnership Level*

Under the centralized system, the audit of a partnership takes place at the partnership level. Any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year, and any partner's distributive share thereof, generally are determined at the partnership level.<sup>763</sup> Any tax attributable to these items generally is assessed and collected at the partnership level. The applicability of any penalty, addition to tax, or additional amount that relates to an adjustment of any item of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year or to any partner's distributive share thereof is determined at the partnership level. Unlike prior law, distinctions between partnership items and affected items are no longer made. An underpayment of tax determined as a result of an examination of a taxable year is imputed to the year during which the adjustment is finally determined, and generally is assessed against and collected from the partnership with respect to that year rather than the reviewed year.

Under the centralized system, a partnership may seek modification of the imputed underpayment amount by providing the Secretary with specified information about the tax status of partners and about the nature and amount of items of income or gain, by means of reviewed-year partners filing amended returns with payment, or on the basis of other factors in regulations or guidance. A partnership may elect an alternative to partnership payment of the imputed underpayment in which each reviewed-year partner is furnished a statement of the partner's share of the adjustments (similar to Schedule K-1) and each such reviewed-year partner increases its tax for the year the statement is furnished. A partnership may file an administrative adjustment request.

Rules are provided relating to statutes of limitation and other applicable time periods, interest and penalties, judicial review, and other aspects of the centralized system.

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<sup>762</sup> Balanced Budget Act of 2015 (BBA of 2015), Public Law 114-74, enacted November 2, 2015.

<sup>763</sup> IRC section 6221(a).

## Partnership Adjustments

### *Partnership Adjustments by the Secretary*

The centralized system provides that any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year and any partner's distributive share thereof, are determined at the partnership level. Any tax attributable to these items is assessed and generally is collected at the partnership level as an imputed underpayment paid by the partnership.

### *Reviewed Year and Adjustment Year*

For purposes of the centralized system, the reviewed year means the partnership taxable year to which the item being adjusted relates. For example, in an examination by the Secretary of a partnership's taxable year 2018, 2018 is the reviewed year.<sup>764</sup>

The adjustment year means: (1) in the case of an adjustment pursuant to the decision of a court (under the centralized system's judicial review rules), the partnership taxable year in which the decision becomes final; (2) in the case of an administrative adjustment request, the partnership taxable year in which the administrative adjustment request is made; or (3) in any other case, the partnership taxable year in which the notice of final partnership adjustment is mailed.<sup>765</sup> For example, in the case of adjustments with respect to partnership taxable year 2018 resulting in an imputed underpayment assessed in 2020 that the partnership then litigates in Tax Court, the decision of which is not appealed and becomes final in 2021, the adjustment year is 2021.

### *Payment of Imputed Underpayment by the Partnership*

Any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year—and any partner's distributive share thereof—are determined at the partnership level. In the event of any adjustment by the Secretary in the amount of any item of income, gain, loss, deduction, or credit of a partnership, or any partner's distributive share, that results in an imputed underpayment, the partnership is required to pay the imputed underpayment in the adjustment year.<sup>766</sup>

### *Interest at Partnership Level*

Interest due is determined at the partnership level and accrues at the rate applicable to underpayments.<sup>767</sup>

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<sup>764</sup> IRC section 6225(d)(1).

<sup>765</sup> IRC section 6225(d)(2).

<sup>766</sup> IRC section 6225(a)(1).

<sup>767</sup> IRC section 6621(a)(2). Rules relating to interest, penalties, and additions to tax are further described below.



### *Adjustment That Does Not Result in Imputed Underpayment*

Any adjustment by the Secretary in the amount of any item of income, gain, loss, deduction, or credit of a partnership, or any partner's distributive share, that does not result in an imputed underpayment is taken into account by the partnership in the adjustment year. The amount of the adjustment is treated as a reduction in non-separately stated income or an increase in non-separately stated loss (whichever is appropriate). It may also be appropriate to treat the amount of an adjustment as a reduction (or increase) in a separately-stated amount of income, gain, loss, or deduction. The amount of an adjustment in a credit is taken into account as a separately-stated item.<sup>768</sup>

### *Determination of Imputed Underpayment Amount*

An imputed underpayment of tax with respect to a partnership adjustment for any reviewed year is determined by netting all adjustments of items of income, gain, loss, or deduction and multiplying the net amount by the highest rate of federal income tax in effect for the reviewed year.<sup>769</sup> Any adjustments to items of credit are taken into account as an increase or decrease, as the case may be, in the figure resulting from this multiplication. Any net increase or decrease in loss is treated as a decrease or increase, respectively, in income. Netting is done taking into account applicable limitations, restrictions, and special rules under present law.

### *Determining Imputed Underpayment Amount: Adjustments to Distributive Shares*

In determining an imputed underpayment, any adjustment that reallocates the distributive share of any item from one partner to another is taken into account by disregarding any decrease in any item of income or gain and disregarding any increase in any item of deduction, loss, or credit.<sup>770</sup>

### New Federal Law (IRC section 6225)

When the Secretary makes adjustments to any partnership-related item with respect to the reviewed year of a partnership, if the adjustments result in an imputed underpayment, the partnership pays an amount equal to the imputed underpayment, and if the adjustments do not result in an imputed underpayment, the adjustments are taken into account by the partnership in the adjustment year and passed through to the adjustment year partners. The provision clarifies this rule by conforming the language referring to partnership-related items and by striking erroneous references to separately stated income or loss.

Additionally, the provision clarifies the manner of netting items to determine the amount of an imputed underpayment of a partnership by clarifying that items of different character (capital or ordinary), for example, are not netted together in determining the amount of an imputed underpayment. Rather, an imputed underpayment of a partnership with respect to a reviewed

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<sup>768</sup> IRC section 6225(a)(2).

<sup>769</sup> IRC section 6225(b)(1). The rule for determining the imputed underpayment applies except as provided in IRC section 6225(c), which provides that the Secretary shall establish procedures under which the imputed underpayment amount may be modified consistent with requirements imposed thereunder.

<sup>770</sup> IRC section 6225(b)(2).

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year is determined by the Secretary by appropriately netting partnership adjustments for that year and by applying the highest rate of tax in effect under sections 1 and 11 for the reviewed year. In the case of partners' distributive shares, like items within categories under section 702(a)(1)-(8), they are separately netted. For example, netting within categories of items that are netted for purposes of reporting to partners on Schedule K-1 pursuant to section 702 may be considered as appropriate netting.

In determining an imputed underpayment, any adjustment that reallocates the distributive share of any item from one partner to another is taken into account by disregarding any part of the adjustment that results in a decrease in the amount of the imputed underpayment. For example, this rule could be implemented by disregarding the decrease in any item of income or gain and disregarding the increase in any item of deduction, loss, or credit.

Limitations that would apply at the direct or indirect partner level are treated as applying, unless otherwise determined. Under the provision, if an adjustment would decrease the imputed underpayment, and could be subject to a limitation or not be allowed against ordinary income if the adjustment were taken into account by any person, then the adjustment is not taken into account in determining the imputed underpayment of the partnership, except to the extent the Secretary otherwise provides.

For example, if an adjustment would increase the amount of a partnership loss allocable to partners, but the loss could be subject to the passive loss rule of section 469 in the hands of direct and indirect partners of the partnership, then the Secretary does not take into account the adjustment increasing the loss in determining the amount of the partnership's imputed underpayment, unless the Secretary provides otherwise. For example, the Secretary may provide otherwise if the partnership supplies accurate information that all direct and indirect partners of the partnership are publicly traded domestic C corporations not subject to the passive loss rule.

Adjustments to credits are separately determined and netted as appropriate. Adjustments to credits are not multiplied by the tax rate, but rather, adjustments to items of credit are taken into account as an increase or decrease in determining the amount of the imputed underpayment.

It is intended that an imputed underpayment may be modified by the Secretary under procedures described in section 6225(c).

### Effective Dates

The amendments made by Title II of this Act shall take effect as if included in section 1101 of the BBA of 2015.

### California Law (R&TC section 18622.5)

For purposes of reporting federal audit adjustments and administrative adjustment requests to the state, California has modified conformity<sup>771</sup>, under the AFITL, including the option to elect to have the new system apply to returns filed for taxable years beginning after November 2, 2015.

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<sup>771</sup> R&TC section 18622.5.

*Netting of Adjustment Items*

California does conform to the federal provisions relating to the netting of items to determine the amount of an imputed underpayment of a partnership, or the amendments made under the Act.<sup>772</sup>

*Federal Imputed Underpayment*

California has stand-alone provisions that determine the California tax of a partnership based on federal adjustments, which rules provide for modifications related to partners that are tax exempt, unitary with the partnership, or California residents (individuals and fiduciaries). These provisions also provide for modification of the federal adjustments based on existing California sourcing rules, and use current California tax rates to determine the tax on the imputed underpayment of the partnership.

Impact on California Revenue

*Netting of Adjustment Items*

Baseline.

*Federal Imputed Underpayment*

Not applicable.

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<u>Section</u>	<u>Section Title</u>
203	Alternative Procedure to Filing Amended Returns for Purposes of Modifying Imputed Underpayment

Background

**Repeal of TEFRA and Electing Large Partnership Rules**

Generally for returns filed for partnership taxable years beginning after 2017,<sup>773</sup> the tax reporting provisions and voluntary centralized audit procedures for electing large partnerships, as well as the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) partnership audit and adjustment rules, are repealed. In place of the repealed procedures, a centralized system for audit, adjustment, assessment, and collection of tax applies to all partnerships, except those eligible partnerships that have filed a valid election out. Electing out of the centralized system leaves

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<sup>772</sup> IRC section 6225.

<sup>773</sup> Balanced Budget Act of 2015 (BBA of 2015), Public Law 114-74, enacted November 2, 2015.

applicable the present-law rules for deficiency proceedings. The centralized system is located in subchapter C of chapter 63 of the IRC.

## Partnership Adjustments

### *Partnership Adjustments by the Secretary*

The centralized system provides that any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year and any partner's distributive share thereof, are determined at the partnership level. Any tax attributable to these items is assessed and generally is collected at the partnership level as an imputed underpayment paid by the partnership.

### *Reviewed Year and Adjustment Year*

For purposes of the centralized system, the reviewed year means the partnership taxable year to which the item being adjusted relates. For example, in an examination by the Secretary of a partnership's taxable year 2018, 2018 is the reviewed year.<sup>774</sup>

The adjustment year means: (1) in the case of an adjustment pursuant to the decision of a court (under the centralized system's judicial review rules), the partnership taxable year in which the decision becomes final; (2) in the case of an administrative adjustment request, the partnership taxable year in which the administrative adjustment request is made; or (3) in any other case, the partnership taxable year in which the notice of final partnership adjustment is mailed.<sup>775</sup> For example, in the case of adjustments with respect to partnership taxable year 2018 resulting in an imputed underpayment assessed in 2020 that the partnership then litigates in Tax Court, the decision of which is not appealed and becomes final in 2021, the adjustment year is 2021.

### *Payment of Imputed Underpayment by the Partnership*

Any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year—and any partner's distributive share thereof—are determined at the partnership level. In the event of any adjustment by the Secretary in the amount of any item of income, gain, loss, deduction, or credit of a partnership, or any partner's distributive share, that results in an imputed underpayment, the partnership is required to pay the imputed underpayment in the adjustment year.<sup>776</sup>

### *Determination of Imputed Underpayment Amount*

An imputed underpayment of tax with respect to a partnership adjustment for any reviewed year is determined by netting all adjustments of items of income, gain, loss, or deduction and multiplying the net amount by the highest rate of federal income tax applicable either to individuals or to

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<sup>774</sup> IRC section 6225(d)(1).

<sup>775</sup> IRC section 6225(d)(2).

<sup>776</sup> IRC section 6225(a)(1).

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corporations that is in effect for the reviewed year.<sup>777</sup> Any adjustments to items of credit are taken into account as an increase or decrease, as the case may be, in the figure resulting from this multiplication. Any net increase or decrease in loss is treated as a decrease or increase, respectively, in income. Netting is done taking into account applicable limitations, restrictions, and special rules under present law.

*Modification of Imputed Underpayment Amount*

Under the centralized system, when an audit of a partnership is commenced, the Secretary notifies the partnership and the partnership representative of the administrative proceeding initiated at the partnership level. The Secretary also notifies the partnership and the partnership representative of any proposed partnership adjustment developed during the proceeding.<sup>778</sup> The Secretary must establish procedures for modification of the amount of an imputed underpayment.<sup>779</sup> One or more modification procedures may be implemented by the partnership after the initiation of the administrative proceeding, including before any notice of proposed adjustment. These procedures include the filing of amended returns by reviewed-year partners, determination of the imputed underpayment without regard to the portion allocable to a tax-exempt partner, and modification of the applicable highest tax rates, including determining the portion of an imputed underpayment to which a lower rate applies.<sup>780</sup> In addition, the Secretary may by regulations or guidance provide for additional procedures to modify imputed underpayment amounts on the basis of factors that the Secretary determines are necessary or appropriate to carry out the function of the modification rules, that is, to determine the amount of tax due as closely as possible to the tax due if the partnership and partners had correctly reported and paid while at the same time implementing the most efficient and prompt assessment and collection of tax attributable to the income of the partnership and partners.

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<sup>777</sup> IRC section 6225(b)(1). The rule for determining the imputed underpayment applies except as provided in IRC section 6225(c), which provides that the Secretary shall establish procedures under which the imputed underpayment amount may be modified consistent with requirements imposed thereunder.

<sup>778</sup> IRC section 6231(a)(1) and (2).

<sup>779</sup> IRC section 6225(c).

<sup>780</sup> See section 411 of the Protecting Americans from Tax Hikes Act of 2015, Division Q of Public Law 114 – 113. Under the provision, certain IRC section 469(k) passive-activity losses can reduce the imputed underpayment of a publicly-traded partnership under the centralized system. The imputed underpayment can be determined without regard to the portion of the underpayment that the partnership demonstrates is attributable to (*i.e.*, would be offset by) specified passive-activity losses attributable to a specified partner. The amount of the specified passive-activity loss is concomitantly decreased, and the partnership takes the net decrease into account as an adjustment in the adjustment year with respect to the specified partners to which the net decrease relates. A specified passive-activity loss for any specified partner of a publicly-traded partnership means the lesser of the IRC section 469(k) passive-activity loss of that partner which is separately determined with respect to the partnership (1) for the partner's taxable year in which or with which the reviewed year of the partnership ends, or (2) for the partner's taxable year in which or with which the adjustment year of the partnership ends. A specified partner is a person who continuously meets each of three requirements for the period starting with the partner's taxable year in which or with which the partnership reviewed year ends through the partner's taxable year in which or with which the partnership adjustment year ends. These three requirements are that the person is a partner of the publicly traded partnership; the person is an individual, estate, trust, closely-held C corporation, or personal service corporation; and the person has a specified passive-activity loss with respect to the publicly-traded partnership.

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Anything required to be submitted pursuant to the modification of the amount of an imputed underpayment must be submitted to the Secretary not later than the close of the 270-day period beginning on the date the notice of a proposed partnership adjustment is mailed, unless the 270-day period is extended with the consent of the Secretary.

Any modification of the amount of an imputed underpayment is made only upon approval of the modification by the Secretary.

*Modification Procedures: Amended Returns of Reviewed-Year Partners*

Payments made by reviewed-year partners with amended returns can reduce the amount of an imputed underpayment.<sup>781</sup> Procedures for modification provide that the amount of an imputed underpayment is determined without regard to the portion of the underpayment taken into account by payment of tax included with amended returns of the reviewed-year partners. The amended return relates to the taxable year of the partner that includes the end of the reviewed year of the partnership. The amended return is to take into account all adjustments in the amount of any item of income, gain, loss, deduction, or credit of the partnership (or any partner's distributive share) properly allocable to each partner, along with changes for any other taxable year with respect to which any tax attribute is affected by reason of the adjustments.

Payment of any tax due is to be included with the amended return. In the case of an adjustment that reallocates the distributive share of any item from one partner to another, this modification procedure is only available if amended returns for the reviewed year are filed by all partners affected by the adjustment.

*Modification Procedures: Tax-Exempt Partners*

Procedures for modification provide for determining the amount of the imputed underpayment without regard to the portion that the partnership demonstrates is allocable to a partner that would not owe tax by reason of its status as a tax-exempt entity for the reviewed year.<sup>782</sup> For this purpose, a tax-exempt entity means (1) the U.S., any state or political subdivision thereof, any possession of the U.S., or any agency or instrumentality of any of these, (2) an organization (other than a cooperative) that is exempt from federal income tax, (3) any foreign person or entity, and (4) any Indian tribal government determined by the Secretary in consultation with the Secretary of the Interior to exercise governmental functions. Under this procedure for modification, the partnership demonstrates the amounts of adjustments that are allocable to the tax-exempt partner and the resulting portion of the imputed underpayment allocable to that partner.<sup>783</sup>

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<sup>781</sup> IRC section 6225(c)(2).

<sup>782</sup> IRC section 6225(c)(3).

<sup>783</sup> IRC sections 6225(c)(3) and 168(h)(2)(A).

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*Modification Procedures: Modification of Applicable Highest Tax Rates*

Procedures for modification provide for taking into account a rate of tax lower than the highest rate of federal income tax applicable either to individuals or to corporations that is in effect for the reviewed year, for certain taxpayer or income types.<sup>784</sup>

The partnership may demonstrate that a portion of an imputed underpayment is allocable to a partner that is a C corporation, and for that C corporation partner, the highest marginal rate of federal income tax (35 percent in 2016, for example) for ordinary income and capital gain<sup>785</sup> for the reviewed year is lower than the highest marginal rate of federal income tax for individuals (39.6 percent in 2016, for example). For a C corporation, the highest marginal rate of federal income tax is the highest rate of tax specified in IRC section 11(b).

Similarly, the partnership may demonstrate that a portion of an imputed underpayment relates to an item of long-term capital gain or qualified dividend income that is allocable to a partner who is an individual, and that the highest rate of tax with respect to that item of long-term capital gain or qualified dividend income for the reviewed year (20 percent for 2016, for example) is lower than the highest rate of federal income tax applicable to individuals for the reviewed year (39.6 percent in 2016, for example). The highest rate for the type of income and type of taxpayer applies under the modification. An S corporation is treated as an individual for this purpose.

In general, the portion of the imputed underpayment to which the lower rate applies with respect to a partner is determined by reference to the partner's distributive share of items of income, gain, loss, deduction, and credit to which the imputed underpayment relates. However, if the partner's distributive share differs among items, then the portion of the imputed underpayment to which the lower rate applies is determined by reference to the amount of the partner's distributive share of net gain or loss if the partnership had sold all of its assets at their fair market value as of the close of the reviewed year.

For example, adjustments are made to a partnership's rental income from property A and its depreciation deductions with respect to property B. A corporate partner has a 20 percent distributive share of rental income from property A, a 15 percent distributive share of depreciation deductions from property B, and a 20 percent distributive share of any gain in the reviewed year. However, if the partnership had sold its assets at fair market value as of the close of the reviewed year, the gain would have been \$100, and based on its capital account, the corporate partner's distributive share would have been \$20. Thus, the portion of the imputed underpayment to which the lower rate applies with respect to the corporate partner is 20 percent.

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<sup>784</sup> IRC section 6225(c)(4).

<sup>785</sup> The Secretary has regulatory authority, including authority to acknowledge or identify the types of income, gain, deduction, and loss to which the lower rate applies. See also section 411 of the Protecting Americans from Tax Hikes Act of 2015, Division Q of Public Law 114-113. A lower rate of tax may be taken into account in the case of either capital gain or ordinary income of a partner that is a C corporation.



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*Modification Procedures: Additional Procedures*

Additional procedures to modify the amount of an imputed underpayment may be provided by the Secretary on the basis of factors the Secretary determines are necessary or appropriate to carry out the purposes of the law. These procedures allow partnerships to demonstrate tax attributes or information with respect to the reviewed year and with respect to reviewed-year partners that could permit modification of the imputed underpayment to more closely approximate the amount of tax due with respect to the reviewed year if the partnership and partners had correctly reported and paid the tax due.

In the absence of regulations or guidance specifically addressing the manner in which these modifications or calculations are made, it is anticipated that partnerships will furnish to the Secretary the necessary documentation, data, and calculations to determine the amount of the reduction of the imputed underpayment with a reasonably high degree of accuracy.

New Federal Law (IRC sections 6201 and 6225)

The provision clarifies the modification rules of IRC section 6225(c) to better carry out their function as intended by Congress, that is, to determine the amount of tax due as closely as possible to the tax due if the partnership and partners had correctly reported and paid while at the same time to implement the most efficient and prompt assessment and collection of tax attributable to the income of the partnership and partners.

The provision clarifies the procedures under IRC section 6225(c)(2) that permit a partnership to seek modification of an imputed underpayment. These procedures allow reviewed-year partners to take adjustments into account so that the partnership's imputed underpayment can be determined by the Secretary without regard to that portion of the adjustments. Like other modification procedures in IRC section 6225(c), these procedures take place within the period ending 270 days after the date the notice of proposed partnership adjustment is mailed, unless the period is extended with the consent of the Secretary, as provided in IRC section 6225(c)(7).

*Amended Returns of Partners*

The provision clarifies the requirements for reviewed-year partners filing amended returns with payment of any tax due. First, the amended return procedure requires the partner to file returns for the taxable year of the partner that includes the end of the partnership's reviewed year, as well as for any taxable year with respect to which any tax attribute of the partner is affected by reason of any adjustment to a reviewed-year partnership-related item. Second, the amended returns are required to take into account all such adjustments that are properly allocable to the partner, as well as the effect of the adjustments on any tax attributes. Third, payment of any tax due is required to be included with the amended returns. The Secretary may require the payment of interest, penalties, and additions to tax (for example, by billing the partner as under present practice).

If the requirements are satisfied, the partnership's imputed underpayment amount is determined without regard to the portion of the adjustments taken into account by such partners. The amended return modification procedure does not require the participation of all reviewed-year

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partners of the partnership; direct and indirect reviewed-year partners may participate, and it is not intended to cover adjustments to items on an amended return of a partner that do not correspond to adjustments to a reviewed-year partnership-related item and the effect of the adjustments on tax attributes.

*Alternative Procedure to Filing Amended Returns (Pull-In)*

Under the provision an alternative procedure to filing amended returns, referred to as the pull-in procedure, is allowed. Under the pull-in procedure, the Secretary determines the partnership's imputed underpayment as reduced by the portion of the adjustments to partnership-related items that direct and indirect reviewed-year partners take into account and with respect to which those partners pay the tax due, provided the requirements of the pull-in procedure are met.

Under pull-in, reviewed-year partners pay the tax that would be due with amended returns, make binding changes to their tax attributes for subsequent years, and provide the Secretary with the information necessary to substantiate that the tax was correctly computed and paid. However, the partners file no amended returns. Thus, there are generally no corollary effects on the partners' returns beyond the effects on tax attributes, in other taxable years, of the adjustments to partnership-related items.

Pull-in, similar to the amended return modification procedure, is available generally to direct and indirect reviewed-year partners (in the case of tiered partnerships). The pull-in procedure generally does not require the participation of all direct and indirect reviewed-year partners of the partnership.

Pull-in requires that the participating partner to:

- Pay the tax that would be due under the amended return filing procedure. The partner is responsible for remitting the payment unless the Secretary provides that another person, such as the partnership or a third party, may remit the payment on the partner's behalf.
- Agree to take into account, in the form and manner required by the Secretary, the adjustments and the effects on the partner's tax attributes of the adjustments to partnership-related items properly allocable to the partner.
- Provide, in the form and manner specified by the Secretary, such information as the Secretary may require to carry out the pull-in procedure. This requirement can include information in the same form as on an amended return, if the Secretary so specifies. The information is to be provided within the period ending 270 days after the date the notice of proposed partnership adjustment is mailed (unless the period is extended with the Secretary's consent).

If all of the requirements are satisfied, the imputed underpayment can be modified. In the event that a partner provides the required information, but does not make the required payment, for example, the imputed underpayment of the partnership is not modified with respect to those adjustments.

For the administrative convenience of taxpayers and the Secretary, it is intended that partner payments and partner information may be collected centrally and remitted to the Secretary under the pull-in procedure. This centralization may be administered by the Secretary, by the partnership representative, or by a third party. For example, the procedure may permit a third party such as an accounting or law firm designated by the partnership representative to collect partner information required under the procedure and tally partner payments before remitting this information to the Secretary. Such a practice may be useful both to facilitate centralized tracking and collection of the information and payments, and to address privacy concerns partners may have in sharing information with the partnership representative. Particularly in the case of partnerships with numerous partners or direct and indirect partners, such a practice may alleviate the administrative burdens on the Secretary and taxpayers, consistent with the Congressional intent for the centralized partnership audit system to improve the efficiency, promptness, and accuracy of collection of partners' taxes due with respect to partnership-related items.

Assessment authority with respect to payments under pull-in is provided under IRC section 6201.

*Rules Applicable Both to the Amended Returns of Partners and to the Pull-In Procedure*

If an adjustment involves reallocation of an item from one partner to another, the opportunity to modify the imputed underpayment under the amended return procedure IRC section 6225(c)(2)(A) or pull-in procedure (IRC section 6225(c)(2)(B)) is available only if the requirements applicable to the relevant procedure are satisfied with respect to all partners affected by the adjustment involving reallocation.

For purposes of the amended return and pull-in procedures, tax relating to adjustments to a reviewed-year partnership-related item and the effect of the adjustments on tax attributes may be determined and assessed without regard to the otherwise applicable statute of limitations of IRC sections 6501 and 6511. For example, if a notice of proposed partnership adjustment is mailed to a partnership by the Secretary more than three years after a partner filed his or her return for the year including the end of the reviewed year, the three-year statute of limitations under IRC section 6501 or 6511 does not preclude the filing of an amended return, the assessment and payment of the partner's tax due for that year, or the proper crediting or refund of an amount paid by a partner, but only with respect to adjustments to partnership-related items for the reviewed year (and the effect of such adjustments on any tax attributes).

For adjustments taken into account on an amended return of a partner or in a pull-in with respect to a partner, the effects of these adjustments on tax attributes are binding and applies for the partner's taxable year that includes the end of the partnership's reviewed year and any taxable year for which a tax attribute is affected by such an adjustment. Any failure to take into account the effects of adjustments on tax attributes is treated in the same manner as a failure by a partner to treat a partnership-related item consistently with the treatment of the item on the partnership return (as provided in IRC section 6222). For example, if a partner who files an amended return or provides information in a pull-in fails to take into account in other taxable years the effect on tax attributes of adjustments to partnership-related items that are properly allocable to that partner, any underpayment attributable to the failure may be assessed under math error procedures as provided in IRC section 6222(b).

The provision clarifies the rules applicable in the case of partnerships and S corporations in tiered structures when a partner files an amended return and pays, or provides information to the Secretary and pays in a pull-in. Specifically, in the case of any partnership, any partner of which is a partnership, the amended return and pull-in rules of IRC section 6225(c)(2)(A) and (B) apply with respect to any partner (the “relevant partner”) in the chain of ownership of such partnerships, provided that certain requirements are met. As a practical matter, this rule generally permits the filing of amended returns even if some, but not all, of the partners (or S corporation shareholders treated as partners for this purpose) file amended returns. Similarly, this rule generally permits some but not all partners to participate in a pull-in, provided requirements are met.

Requirements applicable to both the amended return procedure and the pull-in procedure include the requirement that such information as the Secretary may require be furnished to the Secretary for purposes of administering the amended return or pull-in rules in the case of tiered structures. In this context, the Secretary may require information with respect to any chain of ownership of the relevant partner. The Secretary may require that each partnership in the chain of ownership between the relevant partner and the audited partnership must satisfy the requirements for filing amended returns or for participating in the pull-in, so that all partnerships in the chain of ownership between the relevant partner and the audited partnership either meets the requirement of filing an amended return, or meets the requirements for supplying information in a pull-in.

For example, an audited partnership has three partners, A, B, and C, each of which is a partnership. Partnership B in turn has two partners, D and E, each of which is a partnership. Partnerships A, C, D, and E each have only 5 partners. Individual Q is a partner in Partnership E, and agrees to participate in a pull-in, pay the tax due, and provide information as required by the Secretary (including information similar to that which would be supplied on an amended return of Q, and information with respect to the chain of ownership between Q as the relevant partner and the audited partnership). The provision does not contemplate that the Secretary may require Q to supply information about the chain of ownership between the audited partnership and upper-tier partners of partnerships A, C, or D. However, partners of A, C, or D that file amended returns or participate in the pull-in may be required to supply information on the chain of ownership between themselves and the audited partnership, as well as information on their own chains of ownership should they be partnerships or S corporations.

#### *Other Modification Procedures: References to Adjustments*

The provision clarifies the operation of modification procedures under IRC sections 6225(c)(3) (relating to tax-exempt partners), 6225(c)(4) (relating to applicable highest tax rates), and 6225(c)(5) (relating to certain passive losses of publicly traded partnerships). In each of these modification procedures, the provision clarifies that the determination of the imputed underpayment is made without regard to the adjustment or portion of the adjustment being described (not without regard to a portion of the imputed underpayment).

#### *Other Modification Procedures: Adjustment Not Resulting in an Imputed Underpayment*

The provision specifies that the modification procedures are available if adjustments to partnership-related items do not result in an imputed underpayment. Under

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IRC section 6225(c)(9), information relating to a modification may be offered by the partnership in the case of adjustments that do not result in an imputed underpayment, and such adjustments may be modified by the Secretary as the Secretary determines appropriate.

Effective Dates

The amendments made by Title II of this Act shall take effect as if included in section 1101 of the BBA of 2015.

California Law (R&TC sections 18622 and 18622.5)

For purposes of reporting federal audit adjustments and administrative adjustment requests to the state, California has modified conformity<sup>786</sup>, under the AFITL, to the new federal centralized system for audit, adjustment and assessment of tax for partnerships as in effect January 1, 2018. These federal rules are effective for returns filed for taxable years beginning after December 31, 2017, but include an election to apply the rules to any return filed for taxable years beginning after November 2, 2015.<sup>787</sup>

California does not conform to the federal provisions relating to the modification of partnership imputed underpayments or the amendments made under the Act.<sup>788</sup>

California has stand-alone provisions that determine a partnership tax based on federal adjustments, which provide for modifications related to partners that are tax exempt, unitary with the partnership, or California residents (individuals and fiduciaries). These provisions also provide for modification of the federal adjustments based on existing California sourcing rules, and use current California tax rates to determine the partnership tax. California's stand-alone provisions require partners that file federal amended returns or use the alternative pull-in procedure for the reviewed year, thereby reducing the partnership imputed underpayment,<sup>789</sup> must also report their federal adjustment amounts in accordance with R&TC section 18622.<sup>790</sup>

Impact on California Revenue

Not applicable.

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<sup>786</sup> R&TC section 18622.5.

<sup>787</sup> Enactment date the BBA of 2015, Public Law 114-74.

<sup>788</sup> IRC section 6225(c).

<sup>789</sup> IRC section 6226(c)(2).

<sup>790</sup> This section applies to federal audit adjustments for taxpayers other than partnerships subject to the new centralized federal audit rules.

<u>Section</u>	<u>Section Title</u>
204	Treatment of Passthrough Partners in Tiered Structures

### Background

#### **Repeal of TEFRA and Electing Large Partnership Rules**

Generally for returns filed for partnership taxable years beginning after 2017,<sup>791</sup> the tax reporting provisions and voluntary centralized audit procedures for electing large partnerships, as well as the TEFRA partnership audit and adjustment rules, are repealed. In place of the repealed procedures, a centralized system for audit, adjustment, assessment, and collection of tax applies to all partnerships, except those eligible partnerships that have filed a valid election out. Electing out of the centralized system leaves applicable the present-law rules for deficiency proceedings. The centralized system is located in subchapter C of chapter 63 of the IRC.

#### **In General**

##### *Determination at Partnership Level*

Under the centralized system, the audit of a partnership takes place at the partnership level. Any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year, and any partner's distributive share thereof, generally are determined at the partnership level.<sup>792</sup> Any tax attributable to these items generally is assessed and collected at the partnership level. The applicability of any penalty, addition to tax, or additional amount that relates to an adjustment of any item of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year or to any partner's distributive share thereof is determined at the partnership level. Unlike prior law, distinctions between partnership items and affected items are no longer made. An underpayment of tax determined as a result of an examination of a taxable year is imputed to the year during which the adjustment is finally determined, and generally is assessed against and collected from the partnership with respect to that year rather than the reviewed year.

Under the centralized system, a partnership may seek modification of the imputed underpayment amount by providing the Secretary with specified information about the tax status of partners and about the nature and amount of items of income or gain, by means of reviewed-year partners filing amended returns with payment, or on the basis of other factors in regulations or guidance. A partnership may elect an alternative to partnership payment of the imputed underpayment in which each reviewed-year partner is furnished a statement of the partner's share of the adjustments (similar to Schedule K-1) and each such reviewed-year partner increases its tax for the year the statement is furnished. A partnership may file an administrative adjustment request.

Rules are provided relating to statutes of limitation and other applicable time periods, interest and penalties, judicial review, and other aspects of the centralized system.

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<sup>791</sup> Balanced Budget Act of 2015 (BBA of 2015), Public Law 114-74, enacted November 2, 2015.

<sup>792</sup> IRC section 6221(a).



## Election Out

The centralized system is applicable to any partnership unless it meets eligibility requirements and has made a valid election out for a taxable year.<sup>793</sup>

### *100 or Fewer Statements*

A partnership may elect out of the centralized system (and it and its partners are governed by the present-law deficiency proceedings) for a partnership taxable year if it meets eligibility requirements. One of the eligibility requirements is that for the taxable year, the partnership is required to furnish 100 or fewer statements under IRC section 6031(b) (Schedules K-1) with respect to its partners.

A further eligibility requirement for a partnership to make the election is that each of its partners is an individual, a deceased partner's estate, a C corporation, a foreign entity that would be required to be treated as a C corporation if it were a domestic entity, or an S corporation (provided special rules are met). A partnership with a foreign entity as a partner can meet this eligibility requirement if, under the rules of IRC section 7701, the foreign entity would be taxable as a C corporation if it were domestic; that is, the foreign entity has elected to be, or is, treated as a *per se* corporation under the check-the-box regulatory rules under IRC section 7701.<sup>794</sup>

A C corporation partner that is a regulated investment company or a REIT does not prevent the partnership from being able to elect out, provided the applicable requirements are met.

### *Example*

For example, a partnership is formed to conduct a joint venture between two corporations, X and Y. X's domestic C corporation subsidiary, W, owns a 50-percent interest in the partnership, and Y's domestic C corporation subsidiary, Z, owns a 50-percent interest in the partnership. The partnership is required to furnish two statements (Schedules K-1), one to W and one to Z. The partnership is eligible to elect out of the centralized system for the taxable year, provided that the partnership meets the requirements (described below) as to the time and manner of electing out, including (among other requirements) disclosing to the Secretary the names and employer identification numbers of W and Z.

### *Time and Manner of Election Out*

The election is to be made with a timely-filed return of the partnership taxable year to which the election relates; the election is valid only for that year. The election must include the name and taxpayer identification number of each partner of the partnership in the manner prescribed by the Secretary. The partnership must notify each of its partners of the election in the manner prescribed by the Secretary.

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<sup>793</sup> IRC section 6221(b).

<sup>794</sup> See Treas. Reg. section 301.7701-2 and -3.



### *S Corporation Partners*

For a partnership with a partner that is an S corporation to elect out, the partnership is required to include with its election (in the manner prescribed by the Secretary) a disclosure of the name and taxpayer identification number of each person with respect to whom the S corporation must furnish a statement under IRC section 6037(b) for the S corporation's taxable year ending with or within the partnership's taxable year for which the election is made. This requirement is met if the partnership discloses the name and taxpayer identification number of each S corporation shareholder with respect to which a statement (Schedule K-1) is required to be furnished under IRC section 6037(b). These statements required to be furnished by the S corporation are treated as statements required to be furnished by the partnership for purposes of the 100-or-fewer statements criterion for the partnership's eligibility to elect out.

### *Example*

For example, if a partnership has 50 partners, 49 of which are individuals and one of which is an S corporation with 30 shareholders all of whom are individuals, the partnership is treated as being required to furnish 80 statements. This is the sum of 49 statements for individual partners, one statement for the S corporation partner, and 30 statements for individuals with respect to whom the S corporation must furnish statements. The partnership meets the 100-or-fewer-statements criterion for the partnership's eligibility to elect out.

### *Foreign Partners*

The Secretary may provide for an alternative form of identification of any foreign partners (for example, if the foreign partners do not have U.S. taxpayer identification numbers) for purposes of the requirement of disclosure of the name and taxpayer identification number of each partner by the partnership.

### *Other Persons as Partners*

The Secretary may by regulation or other guidance identify other types of partners to whom rules similar to the special rules in the case of a partner that is an S corporation can apply. This guidance shall take into account, for purposes of applying the 100-or-fewer-statements criterion,<sup>795</sup> each direct and indirect interest in the partnership of any person to which a statement (comparable to the partner statement under IRC section 6031(b)) is required to be furnished by any person. Such guidance may also take into account any person with respect to which a comparable statement is not required to be furnished but which has an interest (direct or indirect) in the partnership. Further, such guidance shall require the partnership to disclose to the Secretary the name and taxpayer identification number of each person with respect to which a statement (comparable to the partner statement under IRC section 6031(b)) is required to be furnished and of other persons with an interest (direct or indirect) in the partnership.

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<sup>795</sup> IRC section 6221(b)(1)(B).

### *Examples*

For example, assume that a partner of a partnership is a disregarded entity such as a state-law limited liability company with only one member, a domestic corporation. Such guidance may provide that the partnership can make the election if the partnership includes (in the manner prescribed by the Secretary) a disclosure of the name and taxpayer identification number of each of the disregarded entity and the corporation that is its sole member, and each of them is taken into account as if each were a statement recipient in determining whether the 100-or-fewer-statements criterion is met.

As another example, such guidance may provide that a partnership with a trust as a partner may make the election if the partnership includes (in the manner prescribed by the Secretary) a disclosure of the name and taxpayer identification number of the trustee, each person who is or is deemed to be an owner of the trust, and any other person that the Secretary determines to be necessary and appropriate, and each one of such persons is taken into account as if each were a statement recipient in determining whether the 100-or-fewer-statements criterion is met. Similar guidance may be provided with respect to a partnership with a partner that is a grantor trust, a former grantor trust that continues in existence for the two-year period following the death of the deemed owner, or a trust receiving property from a decedent's estate for a two-year period.

As a further example, to the extent that such rules are consistent with prompt and efficient collection of tax attributable to the income of partnerships and partners, such guidance may provide rules permitting election out in the case of a partnership (the first partnership) with one or more direct or indirect partners which are themselves partnerships. Under any such guidance with respect to tiered partnerships, the sum of all direct and indirect partners (including each partnership and its partners) may not exceed 100 persons with respect to which an IRC section 6031(b) statement must be furnished, and each partner must be identified. That is, eligibility of the first partnership to make the election requires the first partnership to include (in the manner prescribed by the Secretary) a disclosure of the name and taxpayer identification number of each direct partner of the first partnership and each indirect partner (including each partnership and its partners) in every tier, and requires that each is taken into account in determining whether the 100-or-fewer-statements criterion is met.

### New Federal Law (IRC section 6226)

The provision addresses the situation of a partnership (or an S corporation, treated similarly to a partnership under this rule) that is a direct or indirect partner of an audited partnership that has elected to push-out adjustments of partnership-related items to partners (or S corporation shareholders, treated similarly to partners under this rule) under IRC section 6226. The provision sets forth requirements applicable to such partners and the time frame for satisfying these requirements.

If a partner that receives a statement in a push-out is a partnership, that partner must satisfy two requirements. First, the partner must file with the Secretary a partnership adjustment tracking report that includes information required by the Secretary. For example, the required information may include identifying the partner's own partners or shareholders, describing and quantifying adjustments necessary to determine partnership-related items or the equivalent in the hands of

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those partners or shareholders, or other information necessary or appropriate to assessment and collection from tiers of partners in a push-out.

Second, that partner is required to furnish statements to its partners under rules similar to IRC section 6226(a)(2), or, if no such statements are furnished, to compute and pay its imputed underpayment under rules similar to IRC section 6225 (other than certain modification-related rules). That is, the partnership must push out the adjustments to its partners, or if not, it must compute and pay its imputed underpayment. If such a partnership computes and pays its imputed underpayment, the rules of IRC section 6225 apply (other than the modifications provided in IRC section 6225(c)(2) (amended returns and pull-in), 6225(c)(7) (270-day period for modifications), and 6225(c)(9) (modification of adjustment not resulting in imputed underpayment)). The imputed underpayment of the partnership is determined by appropriately netting all partnership adjustments on the statement (taking into account limitations to which adjustments that decrease the imputed underpayment could be subject) and applying the highest rate of tax in effect for the reviewed year under IRC section 1 or 11, as provided in IRC section 6225. The partnership pays its imputed underpayment as so determined.

The due date for the payment of the imputed underpayment or furnishing of partner statements and the filing of the partnership adjustment tracking report is the return due date (including allowable extensions) for the adjustment year of the audited partnership. That is, the partnership adjustment tracking report must be filed with the Secretary, and the imputed underpayment paid or statements furnished to partners or S corporation shareholders (or if not so furnished, an imputed underpayment must be paid), not later than the due date for the adjustment year of the audited partnership. In the case of a partner that is not a partnership or an S corporation and that receives a statement in a push-out, the partner's tax is increased for the partner's taxable year that includes the date of the statement, as provided in IRC section 6226(b). In the case of a partner that is a trust and that receives a statement in a push-out, regulatory authority to provide any necessary rules is set forth.

The provision defines an audited partnership for purposes of the push-out treatment of pass-through partners in tiered structures under IRC section 6226(b)(4). With respect to a partner that is a partnership or an S corporation and that receives a statement in a push-out, the audited partnership is the partnership in the chain of ownership originally electing the application of IRC section 6226.

#### Effective Dates

The amendments made by Title II of this Act shall take effect as if included in section 1101 of the BBA of 2015.

California Law (R&TC sections 17851, 17865, and 18622.5)

**Federal Partnership Audit Adjustments and Administrative Adjustment Requests**

For purposes of reporting federal audit adjustments and administrative adjustment requests to the state, California has modified conformity<sup>796</sup>, under the AFITL, to the new federal centralized system for audit, adjustment and assessment of tax for partnerships as in effect January 1, 2018. These federal rules are effective for taxable years beginning after December 31, 2017, but include an election to apply the rules to any return filed for taxable years beginning after November 2, 2015.<sup>797</sup>

Because this federal provision is effective as if included in the BBA of 2015, California has modified conformity to the federal changes related to treatment of pass-through partners in tiered structures.

**California Partnership Audit Adjustments and Amended Returns**

California generally conforms to federal laws that govern the taxation of partnerships as of the “specified date” of January 1, 2015,<sup>798</sup> but does not conform to TEFRA audit rules or to the rules relating to electing large partnerships.<sup>799</sup>

For purposes of state audit adjustments and partnership amended returns that are unrelated to federal audit adjustment and administrative adjustment requests, California does not conform to the new federal centralized system for audit, adjustment, and assessment of tax for partnerships, and does not conform to federal partnership-level assessments made in a partnership’s adjustment year for adjustments made to the partnership’s reviewed year.

Under California law, the audit rules generally applicable to taxpayers subject to the state’s personal income tax law apply to partnership audits. Similar to federal law prior to the enactment of this provision, the California tax treatment of an adjustment to a partnership’s items of income, gain, loss, deduction, or credit is determined for each partner in separate proceedings, both administrative and judicial. Adjustments to items of income, gains, losses, deductions, or credits of the partnership generally are made in separate actions for each partner, and each partner has its own separate statute of limitations.

Impact on California Revenue

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<sup>796</sup> R&TC section 18622.5.

<sup>797</sup> Enactment date of the BBA of 2015, Public Law 114-74.

<sup>798</sup> 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, except as otherwise provided.

<sup>799</sup> R&TC section 17865.

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<u>Section</u>	<u>Section Title</u>
205	Treatment of Failure of Partnership to Pay Imputed Underpayment

Background

**Repeal of TEFRA and Electing Large Partnership Rules**

Generally for returns filed for partnership taxable years beginning after 2017,<sup>800</sup> the tax reporting provisions and voluntary centralized audit procedures for electing large partnerships, as well as the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) partnership audit and adjustment rules, are repealed. In place of the repealed procedures, a centralized system for audit, adjustment, assessment, and collection of tax applies to all partnerships, except those eligible partnerships that have filed a valid election out. Electing out of the centralized system leaves applicable the prior-law rules for deficiency proceedings. The centralized system is located in subchapter C of chapter 63 of the IRC.

**Assessment, Collection, and Payment**

An imputed underpayment is assessed and collected in the same manner as if it were a tax imposed for the adjustment year under the federal income tax. The general provisions for assessment, collection and payment under subtitle F of the IRC apply unless superseded by rules of the new centralized system. As a result, an imputed underpayment may be assessed against a partnership if the partnership agrees with the results of the examination, following the expiration of the 90<sup>th</sup> day after issuance of a notice of final partnership adjustment without initiation of judicial proceedings, or in the case of timely judicial proceedings, following the entry of final decision of such proceedings. If no court proceeding is initiated within the 90-day period, the amount that may be assessed against the partnership is limited to the imputed underpayment shown in the notice.

In the case of an administrative adjustment request for which the adjustment is determined and taken into account by the partnership in the partnership taxable year in which the request is made, the imputed underpayment is required to be paid when the request is filed, and is assessed at that time. If the administrative adjustment request is subsequently audited and results in an imputed underpayment greater than that reported and paid with the originally filed request, the additional amount of the imputed underpayment may be assessed in the same manner and subject to the same restrictions as any other imputed underpayment determined after examination.

*Restrictions on Assessment, Levy, and Collection*

The centralized system provides a limitation on the time for assessment of a deficiency as well as levy and court proceedings for collection. Except as otherwise provided, no assessment of a deficiency may be made, and no levy or court proceeding for collection of any amount resulting from an adjustment may be made, begun, or prosecuted with respect to the partnership taxable

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<sup>800</sup> Balanced Budget Act of 2015 (BBA of 2015), Public Law 114-74, enacted November 2, 2015.

year in issue before the close of the 90<sup>th</sup> day after the day that a notice of final partnership adjustment was mailed. If a petition for judicial review is filed, no such assessment may be made and no such levy or court proceeding may be made, begun, or prosecuted before the decision of the court has become final.

A premature action (*i.e.*, one that violates the limitation on the time of assessment, levy, and court proceeding for collection) may be enjoined in the proper court, including the Tax Court. This rule applies notwithstanding the general rule prohibiting suits for the purpose of restraining the assessment or collection of any tax. The Tax Court has no jurisdiction to enjoin any such premature action unless a timely petition for judicial review has been filed, and then only in respect of the adjustments that are the subject of the petition.

Several exceptions to the restrictions on assessment are provided. First, rules similar to the math-error authority under IRC section 6213(b) are permitted as exceptions to the restrictions on assessment described above. The exceptions apply to instances in which a partnership is notified that adjustments to its return are necessary to correct errors arising from mathematical or clerical errors and in the case of a tiered partnership that fails to prepare its partnership return consistently with that of the partnership in which it is a partner. In the case of an inconsistent return position, the rules similar to those in IRC section 6213(b) (providing for subsequent abatement of any resulting assessments if challenged within 60 days) are not applicable. Finally, a partnership may waive the restrictions on the making of any partnership adjustment.

## **Interest and Penalties**

### *Interest*

In general, interest due is determined at the partnership level and accrues at the rate applicable to underpayments. Two periods are relevant in computing the total interest due: (1) the period in which the imputed underpayment of income tax exists, and (2) the period attributable only to late payment of any imputed underpayment after notice and demand. For an imputed underpayment, interest accrues for the period from the due date of the return for the reviewed year until the due date of the adjustment year return, or, if earlier, payment of the imputed tax. If the imputed underpayment is not timely paid with the return for the adjustment year, interest is computed from the return due date for the adjustment year until payment.

If the partnership elects the alternative payment method under IRC section 6226, under which the underpayment is determined at the partner level, the interest due is computed at the partner level. The underpayment interest begins to accrue from the due date of the return for the taxable year to which the increase is attributable, at a rate two percentage points higher than the rate otherwise applicable to underpayments.

### *Penalties*

Generally, the partnership is liable for any penalty, addition to tax, or additional amount. These amounts are determined at the partnership level as if the partnership was an individual who was subject to federal income tax for the reviewed year, and the imputed underpayment was an actual underpayment or understatement for the reviewed year.



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A penalty, addition to tax, or additional amount may apply with respect to an adjustment year return of a partnership in the event of late payment of an imputed underpayment, or, in the case of an election by the partnership under IRC section 6226, with respect to the adjustment year return of a partner. In such cases, the penalty for failure to pay applies. For purposes of accuracy-related and fraud penalties, the determination is made by treating the imputed underpayment as an underpayment of tax.

New Federal Law (IRC section 6232)

Under the provision, if, following an assessment, a partnership fails to pay an imputed underpayment within 10 days after the date of notice and demand by the Secretary, the applicable interest rate increases, and assessment and collection against adjustment-year partners for their proportionate shares may be made. The interest rate under the provision is the underpayment rate as modified, that is, the rate is the sum of the federal short-term rate (determined monthly) plus 5 percentage points. An S corporation and its shareholders are treated like a partnership and its partners under the provision.

The provision applies if, within 10 days of notice and demand for payment, a partnership fails to pay an imputed underpayment under IRC section 6225 or any interest or penalties under IRC section 6233. For example, the increased interest rate applies and assessment and collection from adjustment year partners may be made in the case of a partnership that has not elected under IRC section 6226 to push-out adjustments to partners and nevertheless fails to pay within 10 days of notice and demand.

The provision also applies if any specified similar amount (or interest or penalties with respect to the amount) have not been paid. A specified similar amount arises if a partner that is an upper-tier partnership or S corporation in a push-out fails to pay an imputed underpayment under IRC section 6226(b)(4)(A)(ii) (including any failure to furnish statements that is treated as a failure to pay an imputed underpayment under IRC section 6651(i)). A specified similar amount also includes an amount required to be paid by former partners (including partners that are themselves partnerships) of a partnership that has ceased to exist or terminated (not including a technical termination) as well as interest or penalties with respect to the amount.

The date of the notice and demand for payment initiates a two-year period in which the Secretary may assess against the adjustment-year partners (or former partners). The two-year period of limitations also applies to a proceeding begun in court without assessment with respect to a partner. The period may be extended by agreement.

The provision expands the present-law IRC section 6501(c)(4) rule permitting extension by agreement between the Secretary and the taxpayer of the time period for assessment. As a result, that rule permitting extension by agreement is not limited to assessment periods prescribed in IRC section 6501, but rather, applies more broadly to assessment periods and in particular applies to the period for assessment against partners in the case of failure of a partnership to pay an imputed underpayment after notice and demand under IRC section 6232(f).

If a partnership has ceased to exist or terminated (not including a technical termination) within the meaning of IRC section 6241(7), the provision applies with respect to the former partners of the



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partnership. For example, the former partners of the partnership may be the partners for the most recent period before the partnership ceased to exist or terminated, such as the partners for purposes of the last return filed by the partnership.

A partner is liable for no more than the partner's proportionate share of the imputed underpayment, interest, and penalties, measured as the Secretary determines on the basis of the partner's distributive share of items. For example, the distributive shares set forth in the partnership agreement, or as determined for purposes of Schedule K-1, may serve as a measure of a partner's proportionate share. The Secretary is required to determine partners' proportionate shares so that the aggregate proportionate shares so determined total 100 percent. Thus, no partner is required to pay more than the partner's proportionate share of the imputed underpayment, interest, and penalties.

Partner payments under this provision reduce the partnership's liability to pay. The partnership's liability is not reduced by partner payments if such payments are made after the date on which the partnership pays, however. For example, if a partnership's liability is \$100, and partner payments aggregating \$60 before July 15 reduce the partnership's liability to \$40, and the partnership pays \$40 on July 15, a partner payment of \$40 on August 1 does not reduce the partnership's liability. The partnership may not receive a credit or refund for any part of the partner payment of \$40; the partner, however, may.

The Secretary may assess the tax, interest, and penalties on the proportionate share of each partner (as of the close of the adjustment year) of the partnership without regard to the deficiency procedures generally applicable to income tax. Under the provision, assessment may not be made (or proceeding in court begun without assessment) after the date that is two years after the date on which the Secretary provides notice and demand.

### Effective Dates

The amendments made by Title II of this Act shall take effect as if included in section 1101 of the BBA of 2015.

California Law (R&TC sections 17851, 17865, 18622.5, 19001, 19033, 19101-19120, 19137-19187)

### **Federal Partnership Audit Adjustments and Administrative Adjustment Requests**

For purposes of reporting federal audit adjustments and administrative adjustment requests to the state, California has modified conformity<sup>801</sup>, under the AFITL, to the new federal centralized system for audit, adjustment and assessment of tax for partnerships as in effect January 1, 2018. These federal rules are effective for taxable years beginning after December 31, 2017, but include an election to apply the rules to any return filed for taxable years beginning after November 2, 2015.<sup>802</sup>

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<sup>801</sup> R&TC section 18622.5.

<sup>802</sup> Enactment date of the BBA of 2015, Public Law 114-74.

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California does not conform to the assessment, collection, and payment provisions within the new federal centralized audit rules for partnerships or the amendments made under the Act, and instead has standalone language relating to these provisions.

### California Partnership Audit Adjustments and Amended Returns

California generally conforms for purposes of state audit adjustments and partnership amended returns that are unrelated to federal audit adjustments and administrative adjustment requests to federal laws that govern the taxation of partnerships as of the “specified date” of January 1, 2015,<sup>803</sup> but does not conform to TEFRA audit rules or to the rules relating to electing large partnerships.<sup>804</sup>

Under California law, the audit rules generally applicable to taxpayers subject to the state’s personal income tax apply to partnership audits. Similar to federal law prior to the enactment of this provision, the California tax treatment of an adjustment to a partnership’s items of income, gain, loss, deduction, or credit is determined for each partner in separate proceedings, both administrative and judicial. Adjustments to items of income, gains, losses, deductions, or credits of the partnership generally are made in separate actions for each partner, and each partner has its own separate statute of limitations.

Except for federal audit adjustments and administrative adjustment requests, California does not conform to the new federal centralized system for audit, adjustment, and assessment of tax for partnerships, and does not conform to federal partnership-level assessments made in a partnership’s adjustment year for adjustments made to the partnership’s reviewed year.

#### Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
206	Other Technical Corrections Related to Partnership Audit Rules

#### Background

### Repeal of TEFRA and Electing Large Partnership Rules

Generally for returns filed for partnership taxable years beginning after 2017,<sup>805</sup> the tax reporting provisions and voluntary centralized audit procedures for electing large partnerships, as well as the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) partnership audit and adjustment

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<sup>803</sup> 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, except as otherwise provided.

<sup>804</sup> R&TC section 17865.

<sup>805</sup> Balanced Budget Act of 2015 (BBA of 2015), Public Law 114-74, enacted November 2, 2015.

rules, are repealed. In place of the repealed procedures, a centralized system for audit, adjustment, assessment, and collection of tax applies to all partnerships, except those eligible partnerships that have filed a valid election out. Electing out of the centralized system leaves applicable the present-law rules for deficiency proceedings. The centralized system is located in subchapter C of chapter 63 of the IRC.

## **In General**

### *Determination at Partnership Level*

Under the centralized system, the audit of a partnership takes place at the partnership level. Any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year, and any partner's distributive share thereof, generally are determined at the partnership level.<sup>806</sup> Any tax attributable to these items generally is assessed and collected at the partnership level. The applicability of any penalty, addition to tax, or additional amount that relates to an adjustment of any item of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year or to any partner's distributive share thereof is determined at the partnership level. Unlike prior law, distinctions between partnership items and affected items are no longer made. An underpayment of tax determined as a result of an examination of a taxable year is imputed to the year during which the adjustment is finally determined, and generally is assessed against and collected from the partnership with respect to that year rather than the reviewed year.

Under the centralized system, a partnership may seek modification of the imputed underpayment amount by providing the Secretary with specified information about the tax status of partners and about the nature and amount of items of income or gain, by means of reviewed-year partners filing amended returns with payment, or on the basis of other factors in regulations or guidance. A partnership may elect an alternative to partnership payment of the imputed underpayment in which each reviewed-year partner is furnished a statement of the partner's share of the adjustments (similar to Schedule K-1) and each such reviewed-year partner increases its tax for the year the statement is furnished. A partnership may file an administrative adjustment request.

Rules are provided relating to statutes of limitation and other applicable time periods, interest and penalties, judicial review, and other aspects of the centralized system.

## **Election Out**

The centralized system is applicable to any partnership unless it meets eligibility requirements and has made a valid election out for a taxable year.<sup>807</sup>

### *100 or Fewer Statements*

A partnership may elect out of the centralized system (and it and its partners are governed by the present-law deficiency proceedings) for a partnership taxable year if it meets eligibility

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<sup>806</sup> IRC section 6221(a).

<sup>807</sup> IRC section 6221(b).

requirements. One of the eligibility requirements is that for the taxable year, the partnership is required to furnish 100 or fewer statements under IRC section 6031(b) (Schedules K-1) with respect to its partners.

A further eligibility requirement for a partnership to make the election is that each of its partners is an individual, a deceased partner's estate, a C corporation, a foreign entity that would be required to be treated as a C corporation if it were a domestic entity, or an S corporation (provided special rules are met). A partnership with a foreign entity as a partner can meet this eligibility requirement if, under the rules of IRC section 7701, the foreign entity would be taxable as a C corporation if it were domestic; that is, the foreign entity has elected to be, or is, treated as a *per se* corporation under the check-the-box regulatory rules under IRC section 7701.<sup>808</sup>

A C corporation partner that is a regulated investment company or a REIT does not prevent the partnership from being able to elect out, provided the applicable requirements are met.

#### *Time and Manner of Election Out*

The election is to be made with a timely-filed return of the partnership taxable year to which the election relates; the election is valid only for that year. The election must include the name and taxpayer identification number of each partner of the partnership in the manner prescribed by the Secretary. The partnership must notify each of its partners of the election in the manner prescribed by the Secretary.

#### *S Corporation Partners*

For a partnership with a partner that is an S corporation to elect out, the partnership is required to include with its election (in the manner prescribed by the Secretary) a disclosure of the name and taxpayer identification number of each person with respect to whom the S corporation must furnish a statement under IRC section 6037(b) for the S corporation's taxable year ending with or within the partnership's taxable year for which the election is made. This requirement is met if the partnership discloses the name and taxpayer identification number of each S corporation shareholder with respect to which a statement (Schedule K-1) is required to be furnished under IRC section 6037(b). These statements required to be furnished by the S corporation are treated as statements required to be furnished by the partnership for purposes of the 100-or-fewer statements criterion for the partnership's eligibility to elect out.

#### *Foreign Partners*

The Secretary may provide for an alternative form of identification of any foreign partners (for example, if the foreign partners do not have U.S. taxpayer identification numbers) for purposes of the requirement of disclosure of the name and taxpayer identification number of each partner by the partnership.

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<sup>808</sup> See Treas. Reg. section 301.7701-2 and -3.

### *Other Persons as Partners*

The Secretary may by regulation or other guidance identify other types of partners to whom rules similar to the special rules in the case of a partner that is an S corporation can apply. This guidance shall take into account, for purposes of applying the 100-or-fewer-statements criterion,<sup>809</sup> each direct and indirect interest in the partnership of any person to which a statement (comparable to the partner statement under IRC section 6031(b)) is required to be furnished by any person. Such guidance may also take into account any person with respect to which a comparable statement is not required to be furnished but which has an interest (direct or indirect) in the partnership. Further, such guidance shall require the partnership to disclose to the Secretary the name and taxpayer identification number of each person with respect to which a statement (comparable to the partner statement under IRC section 6031(b)) is required to be furnished and of other persons with an interest (direct or indirect) in the partnership.

### **Requirement of Consistency with Partnership Return**

#### *In General*

The centralized system imposes a consistency requirement. A partner on its return must treat each item of income, gain, loss, deduction or credit attributable to a partnership in a manner that is consistent with the treatment of such income, gain, loss, deduction, or credit on the partnership return. An underpayment that results from a failure of a partner to conform to the partnership reporting of an item is treated as a math error on the partner's return and cannot be abated under IRC section 6213(b)(2). The underpayment may be subject to additions to tax.

#### *Notice of Inconsistent Position*

If the partnership has filed a return but the partner's treatment on the partner's return is (or may be) inconsistent with the partnership's return, or if the partnership has not filed a return, the math-error treatment and non-abatement treatment do not apply if the partner files a statement identifying the inconsistent position. Further, a partner is treated as having complied with the obligation to file a statement identifying the inconsistent position in the circumstance in which the partner demonstrates to the satisfaction of the Secretary that the treatment of the item on the partner's return is consistent with the treatment of the item on the statement furnished to the partner by the partnership, and the partner elects the application of this rule.

A final decision in an administrative or judicial proceeding with respect to a partnership under the centralized system is binding on the partnership and all partners of the partnership. In contrast, a final determination in an administrative or judicial proceeding with respect to a partner's identified inconsistent position is not binding on the partnership if the partnership is not a party to the proceeding. No inference is intended that the partnership is bound by any other proceeding to which it is not a party, such as an administrative or judicial proceeding with respect to a partner's unidentified inconsistent position.

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<sup>809</sup> IRC section 6221(b)(1)(B).

## Partners Bound by Actions of Partnership; Designation of Partnership Representative

For purposes of the centralized system, the partnership acts through its partnership representative. The partnership representative has the sole authority to act on behalf of the partnership under the centralized system.<sup>810</sup> Under the centralized system, the partnership and all partners of the partnership are bound by actions taken by the partnership.<sup>811</sup> Thus, for example, partners may not participate in or contest results of an examination of a partnership by the Secretary. A partnership and all partners of the partnership are also bound by any final decision in a proceeding with respect to the partnership brought under the centralized system of subchapter C of the IRC. Thus, for example, a settlement agreement entered into by the partnership, a notice of final partnership adjustment with respect to the partnership that is not contested, or the final decision of the court with respect to the partnership if the notice of final partnership adjustment is contested bind the partnership and all partners of the partnership.

Each partnership is required to designate a partner (or other person) with a substantial presence in the U.S. as the partnership representative. A substantial presence in the U.S. enables the partnership representative to meet with the Secretary in the U.S. as is necessary or appropriate, and facilitates communication during the audit process and during any other proceedings in which the partnership is involved. In any case in which such a designation by the partnership is not in effect, the Secretary may select any person as the partnership representative.

## Partnership Adjustments

### *Partnership Adjustments by the Secretary*

The centralized system provides that any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year, and any partner's distributive share thereof, are determined at the partnership level. Any tax attributable to these items is assessed and generally is collected at the partnership level as an imputed underpayment paid by the partnership.

### *Reviewed Year and Adjustment Year*

For purposes of the centralized system, the reviewed year means the partnership taxable year to which the item being adjusted relates. For example, in an examination by the Secretary of a partnership's taxable year 2018, 2018 is the reviewed year.<sup>812</sup>

The adjustment year means: (1) in the case of an adjustment pursuant to the decision of a court (under the centralized system's judicial review rules), the partnership taxable year in which the decision becomes final; (2) in the case of an administrative adjustment request, the partnership taxable year in which the administrative adjustment request is made; or (3) in any other case, the partnership taxable year in which the notice of final partnership adjustment is mailed.<sup>813</sup> For

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<sup>810</sup> IRC section 6223(a).

<sup>811</sup> IRC section 6223(b).

<sup>812</sup> IRC section 6225(d)(1).

<sup>813</sup> IRC section 6225(d)(2).

example, in the case of adjustments with respect to partnership taxable year 2018 resulting in an imputed underpayment assessed in 2020 that the partnership then litigates in Tax Court, the decision of which is not appealed and becomes final in 2021, the adjustment year is 2021.

#### *Payment of Imputed Underpayment by the Partnership*

Any adjustment to items of income, gain, loss, deduction, or credit of a partnership for a partnership taxable year—and any partner’s distributive share thereof—are determined at the partnership level. In the event of any adjustment by the Secretary in the amount of any item of income, gain, loss, deduction, or credit of a partnership, or any partner’s distributive share, that results in an imputed underpayment, the partnership is required to pay the imputed underpayment in the adjustment year.<sup>814</sup>

#### *Interest at Partnership Level*

Interest due is determined at the partnership level and accrues at the rate applicable to underpayments.<sup>815</sup>

#### *Adjustment That Does Not Result in Imputed Underpayment*

Any adjustment by the Secretary in the amount of any item of income, gain, loss, deduction, or credit of a partnership, or any partner’s distributive share, that does not result in an imputed underpayment is taken into account by the partnership in the adjustment year. The amount of the adjustment is treated as a reduction in non-separately stated income or an increase in non-separately stated loss (whichever is appropriate). It may also be appropriate to treat the amount of an adjustment as a reduction (or increase) in a separately-stated amount of income, gain, loss, or deduction. The amount of an adjustment in a credit is taken into account as a separately-stated item.<sup>816</sup>

#### *Determination of Imputed Underpayment Amount*

An imputed underpayment of tax with respect to a partnership adjustment for any reviewed year is determined by netting all adjustments of items of income, gain, loss, or deduction and multiplying the net amount by the highest rate of federal income tax applicable either to individuals or to corporations that is in effect for the reviewed year.<sup>817</sup> Any adjustments to items of credit are taken into account as an increase or decrease, as the case may be, in the figure resulting from this multiplication. Any net increase or decrease in loss is treated as a decrease or increase, respectively, in income. Netting is done taking into account applicable limitations, restrictions, and special rules under present law.

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<sup>814</sup> IRC section 6225(a)(1).

<sup>815</sup> IRC section 6621(a)(2). Rules relating to interest, penalties, and additions to tax are further described below.

<sup>816</sup> IRC section 6225(a)(2).

<sup>817</sup> IRC section 6225(b)(1). The rule for determining the imputed underpayment applies except as provided in IRC section 6225(c), which provides that the Secretary shall establish procedures under which the imputed underpayment amount may be modified consistent with requirements imposed thereunder.



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*Determining Imputed Underpayment Amount: Adjustments to Distributive Shares*

In determining an imputed underpayment, any adjustment that reallocates the distributive share of any item from one partner to another is taken into account by disregarding any decrease in any item of income or gain and disregarding any increase in any item of deduction, loss, or credit.<sup>818</sup>

*Modification of Imputed Underpayment Amount*

When an audit of a partnership is commenced, the Secretary notifies the partnership and the partnership representative of the administrative proceeding initiated at the partnership level. The Secretary also notifies the partnership and the partnership representative of any proposed partnership adjustment developed during the proceeding.<sup>819</sup> The Secretary must establish procedures for modification of the amount of an imputed underpayment.<sup>820</sup> One or more modification procedures may be implemented by the partnership after the initiation of the administrative proceeding, including before any notice of proposed adjustment.

These procedures include the filing of amended returns by reviewed-year partners, determination of the imputed underpayment without regard to the portion of it allocable to a tax-exempt partner, and modification of the applicable highest tax rates, including determining the portion of an imputed underpayment to which a lower rate applies.<sup>821</sup> In addition, the Secretary may by regulations or guidance provide for additional procedures to modify imputed underpayment amounts on the basis of factors that the Secretary determines are necessary or appropriate to carry out the function of the modification rules, that is, to determine the amount of tax due as closely as possible to the tax due if the partnership and partners had correctly reported and paid while at the same time to implement the most efficient and prompt assessment and collection of tax attributable to the income of the partnership and partners.

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<sup>818</sup> IRC section 6225(b)(2).

<sup>819</sup> IRC section 6231(a)(1) and (2).

<sup>820</sup> IRC section 6225(c).

<sup>821</sup> See section 411 of the Protecting Americans from Tax Hikes Act of 2015, Division Q of Public Law 114-113. Under the provision, certain IRC section 469(k) passive-activity losses can reduce the imputed underpayment of a publicly-traded partnership under the centralized system. The imputed underpayment can be determined without regard to the portion of the underpayment that the partnership demonstrates is attributable to (*i.e.*, would be offset by) specified passive-activity loss attributable to a specified partner. The amount of the specified passive-activity loss is concomitantly decreased, and the partnership takes the net decrease into account as an adjustment in the adjustment year with respect to the specified partners to which the net decrease relates. A specified passive-activity loss for any specified partner of a publicly-traded partnership means the lesser of the IRC section 469(k) passive-activity loss of that partner which is separately determined with respect to the partnership (1) for the partner's taxable year in which or with which the reviewed year of the partnership ends, or (2) for the partner's taxable year in which or with which the adjustment year of the partnership ends. A specified partner is a person who continuously meets each of three requirements for the period starting with the partner's taxable year in which or with which the partnership reviewed year ends through the partner's taxable year in which or with which the partnership adjustment year ends. These three requirements are that the person is a partner of the publicly traded partnership; the person is an individual, estate, trust, closely-held C corporation, or personal service corporation; and the person has a specified passive-activity loss with respect to the publicly-traded partnership.

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Anything required to be submitted pursuant to the modification of the amount of an imputed underpayment must be submitted to the Secretary not later than the close of the 270-day period beginning on the date the notice of a proposed partnership adjustment is mailed, unless the 270-day period is extended with the consent of the Secretary.

Any modification of the amount of an imputed underpayment is made only upon approval of the modification by the Secretary.

*Modification Procedures: Amended Returns of Reviewed-Year Partners*

Payments made by reviewed-year partners with amended returns can reduce the amount of an imputed underpayment.<sup>822</sup> Procedures for modification provide that the amount of an imputed underpayment is determined without regard to the portion of the underpayment taken into account by payment of tax included with amended returns of the reviewed-year partners. The amended return relates to the taxable year of the partner that includes the end of the reviewed year of the partnership. The amended return is to take into account all adjustments in the amount of any item of income, gain, loss, deduction, or credit of the partnership (or any partner's distributive share) properly allocable to each partner, along with changes for any other taxable year with respect to which any tax attribute is affected by reason of the adjustments.

Payment of any tax due is to be included with the amended return. In the case of an adjustment that reallocates the distributive share of any item from one partner to another, this modification procedure is only available if amended returns for the reviewed year are filed by all partners affected by the adjustment.

*Modification Procedures: Tax-Exempt Partners*

Procedures for modification provide for determining the amount of the imputed underpayment without regard to the portion of it that the partnership demonstrates is allocable to a partner that would not owe tax by reason of its status as a tax-exempt entity for the reviewed year.<sup>823</sup> For this purpose, a tax-exempt entity means (1) the U.S., any state or political subdivision thereof, any possession of the U.S., or any agency or instrumentality of any of these, (2) an organization (other than a cooperative) that is exempt from federal income tax, (3) any foreign person or entity, and (4) any Indian tribal government determined by the Secretary in consultation with the Secretary of the Interior to exercise governmental functions. Under this procedure for modification, the partnership demonstrates the amounts of adjustments that are allocable to the tax-exempt partner and the resulting portion of the imputed underpayment allocable to that partner.<sup>824</sup>

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<sup>822</sup> IRC section 6225(c)(2).

<sup>823</sup> IRC section 6225(c)(3).

<sup>824</sup> IRC sections 6225(c)(3) and 168(h)(2)(A).

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*Modification Procedures: Modification of Applicable Highest Tax Rates*

Procedures for modification provide for taking into account a rate of tax lower than the highest rate of federal income tax applicable either to individuals or to corporations that is in effect for the reviewed year, for certain types of taxpayers or types of income.<sup>825</sup>

The partnership may demonstrate that a portion of an imputed underpayment is allocable to a partner that is a C corporation, and for that C corporation partner, the highest marginal rate of federal income tax (35 percent in 2016, for example) for ordinary income and capital gain<sup>826</sup> for the reviewed year is lower than the highest marginal rate of federal income tax for individuals (39.6 percent in 2016, for example). For a C corporation, the highest marginal rate of federal income tax is the highest rate of tax specified in IRC section 11(b).

Similarly, the partnership may demonstrate that a portion of an imputed underpayment relates to an item of long-term capital gain or qualified dividend income that is allocable to a partner who is an individual, and that the highest rate of tax with respect to that item of long-term capital gain or qualified dividend income for the reviewed year (20 percent for 2016, for example) is lower than the highest rate of federal income tax applicable to individuals for the reviewed year (39.6 percent in 2016, for example). The highest rate for the type of income and type of taxpayer applies under the modification. An S corporation is treated as an individual for this purpose.

In general, the portion of the imputed underpayment to which the lower rate applies with respect to a partner is determined by reference to the partner's distributive share of items of income, gain, loss, deduction, and credit to which the imputed underpayment relates. However, if the partner's distributive share differs among items, then the portion of the imputed underpayment to which the lower rate applies is determined by reference to the amount of the partner's distributive share of net gain or loss if the partnership had sold all of its assets at their fair market value as of the close of the reviewed year.

*Modification Procedures: Additional Procedures*

Additional procedures to modify the amount of an imputed underpayment may be provided by the Secretary on the basis of factors the Secretary determines are necessary or appropriate to carry out the purposes of the law. These procedures allow partnerships to demonstrate tax attributes or information with respect to the reviewed year and with respect to reviewed-year partners that could permit modification of the imputed underpayment to more closely approximate the amount of tax due with respect to the reviewed year if the partnership and partners had correctly reported and paid the tax due.

In the absence of regulations or guidance specifically addressing the manner in which these modifications or calculations are made, it is anticipated that partnerships will furnish to the

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<sup>825</sup> IRC section 6225(c)(4).

<sup>826</sup> The Secretary has regulatory authority, including authority to acknowledge or identify the types of income, gain, deduction, and loss to which the lower rate applies. See also section 411 of the Protecting Americans from Tax Hikes Act of 2015, Division Q of Public Law 114-113. A lower rate of tax may be taken into account in the case of either capital gain or ordinary income of a partner that is a C corporation.

Secretary the necessary documentation, data, and calculations to determine the amount of the reduction of the imputed underpayment with a reasonably high degree of accuracy.

### **Alternative to Payment of Imputed Underpayment by Partnership**

As an alternative to partnership payment of the imputed underpayment in the adjustment year, the audited partnership may elect to furnish to the Secretary and to each partner of the partnership for the reviewed year a statement of the partner's share of any adjustments to income, gain, loss, deduction and credit as determined in the notice of final partnership adjustment.<sup>827</sup> In this case, each such partner takes these adjustments into account and pays the tax.<sup>828</sup>

#### *Payment by Reviewed-Year Partners in Year that Includes Date of the Statement*

The reviewed-year partner's tax is increased for the partner's taxable year that includes the date of the statement.

#### *Amount of the Reviewed-Year Partner's Adjustment*

The reviewed-year partner's tax is increased by an amount equal to the aggregate of the adjustment amounts determined. This includes the amount by which the partner's tax would increase if the partner's distributive share of the adjustment amounts were included for the partner's taxable year that includes the end of the reviewed year, plus the amount by which the tax would increase by reason of adjustment to tax attributes in years after that year of the partner and before the year of the date of the statement. Tax attributes in any subsequent taxable year are required to be appropriately adjusted.

#### *Penalties, Additions to Tax, Additional Amounts*

Penalties, additions to tax, and additional amounts, are determined at the partnership level;<sup>829</sup> each reviewed-year partner is liable for its share of the penalty, addition to tax, and additional amount.<sup>830</sup>

#### *Interest at Partner Level from Reviewed Year, with Adjustments*

In the case of an imputed underpayment for which an election is made, interest is determined at the partner level.<sup>831</sup> Interest is determined from the due date of the partner's return for the taxable year to which the increase is attributable. Interest is determined taking into account any increases attributable to a change in tax attributes for an intervening tax year.

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<sup>827</sup> IRC section 6226(a).

<sup>828</sup> IRC section 6226(b).

<sup>829</sup> IRC sections 6221 and 6226(c).

<sup>830</sup> IRC section 6226(c).

<sup>831</sup> IRC section 6226(c)(2).

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The rate of interest determined at the partner level is the underpayment rate as modified, that is, the rate is the sum of the federal short-term rate (determined monthly) plus 5 percentage points.

*Time and Manner of Making Election*

The partnership may make this election not later than 45 days after the notice of final partnership adjustment.<sup>832</sup> The election is revocable only with the consent of the Secretary. The election may be made whether or not the partnership files a petition for judicial review of the notice of final partnership adjustment.

The partnership may make the election within 45 days from the notice of final partnership adjustment, and within 90 days from the notice of final partnership adjustment may file a petition for readjustment with the Tax Court, district court, or Court of Federal Claims. Upon the final court decision, dismissal of the case, or settlement, the partnership is to implement the election by furnishing statements (at the time and manner prescribed by the Secretary) to the reviewed-year partners showing each partner's share of the adjustments as finally determined. As part of any settlement, for example, it is contemplated that the Secretary may permit revocation of a previously made election, and the partnership may pay at the partnership level.

*Time and Manner of Furnishing Statement*

The statement is to be furnished to the Secretary and to partners within such time and in such manner as is prescribed by the Secretary. In the absence of such guidance, the statements are to be furnished to the Secretary and to all partners within a reasonable period following the last day on which an election is allowed to be made. The date the statement is furnished (as well as the date of the statement) is the date the statement is mailed, for this purpose.

*Information Furnished on Statement to the Secretary and to Partners*

The statement furnished to the Secretary and to partners is to include the amounts of and tax attributes of the adjustments allocable to the recipient partner. Under regulatory authority, the Secretary may require the statement to show the amount of the imputed underpayment allocable to the recipient partner. In addition, the statement is to include the name and taxpayer identification number of the recipient partner. The Secretary may require that the statement include such additional information as is necessary or appropriate to carry out the purposes of the law, such as the address of the recipient partner and the date the statement is mailed.

*Treatment of Tiered Partnerships and Other Tiered Entities*

In the case of tiered partnerships, a partnership that receives a statement from the audited partnership is treated similarly to an individual who receives a statement from the audited partnership. That is, the recipient partnership takes into account the aggregate of the adjustment amounts determined for the partner's taxable year including the end of the reviewed year, plus the adjustments to tax attributes in the following taxable years of the recipient partnership. The recipient partnership pays the tax attributable to adjustments with respect to the reviewed year

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<sup>832</sup> IRC section 6226(a)(1).

and the intervening years, calculated as if it were an individual (consistently with IRC section 703), for the taxable year that includes the date of the statement. The recipient partnership, its partners in the taxable year that is the reviewed year of the audited partnership, and its partners in the year that includes the date of the statement, may have entered into indemnification agreements under the partnership agreement with respect to the risk of tax liability of reviewed-year partners being borne economically by partners in the year that includes the date of the statement. Because the payment of tax by a partnership under the centralized system is nondeductible, payments under an indemnification or similar agreement with respect to the tax are nondeductible.

A recipient partner that is a RIC or REIT and that receives a statement from an audited partnership including adjustments for a prior (reviewed) year may wish to make a deficiency dividend with respect to the reviewed year. Guidance coordinating the receipt of a statement from an audited partnership by a RIC or REIT with the deficiency dividend procedures is expected to be issued by the Secretary.

### **Administrative Adjustment Request by Partnership**

A partnership may file a request for an administrative adjustment in the amount of one or more items of income, gain, loss, deduction, or credit of the partnership for a partnership taxable year. Following the filing of the administrative adjustment request, the partnership may apply most of the procedures for modification in a manner similar to modification of an imputed underpayment under new IRC section 6225(c). Like the partnership audit, tax resulting from the adjustment may be paid by the partners in the manner in which a partnership pays an imputed underpayment in the adjustment year under new IRC section 6225. Alternatively, the adjustment may be taken into account by the partnership and partners, and the tax paid by reviewed-year partners upon receipt of statements showing the adjustments, similar to new IRC section 6226. However, in the case of an adjustment (pursuant to a partnership's administrative adjustment request) that would not result in an imputed underpayment, any refund is not paid to the partnership; rather, procedures similar to the procedure for furnishing reviewed-year partners with statements reflecting the requested adjustment apply, with appropriate adjustments.

#### *Time for Making Administrative Adjustment Request*

A partnership may not file an administrative adjustment request more than three years after the later of (1) the date on which the partnership return for the year in question is filed, or (2) the last day for filing the partnership return for that year (without extensions).

In no event may a partnership file an administrative adjustment request after a notice of an administrative proceeding with respect to the taxable year is mailed.

#### *Tiered Partnerships*

In the case of tiered partnerships, a partnership's partners that are themselves partnerships may choose to file an administrative adjustment request with respect to their distributive shares of an adjustment. The partners and indirect partners that are themselves partnerships may choose to



coordinate the filing of administrative adjustment requests as a group to the extent permitted by the Secretary.

## **Procedural Rules**

### *In General*

The new centralized system provides rules governing notices, time limitations, restrictions on assessment and the imposition of interest and penalties in the context of a partnership adjustment. Specific grants of regulatory authority are provided to address the identification of foreign partners, the manner of notifying partners of an election out of centralized procedures, the manner in which a partnership representative is selected, and the extent to which the new centralized system may be applied before the generally applicable effective date.

### *Notice of Proceedings and Adjustments*

The centralized system contemplates three types of principal notifications by the Secretary to the partnership and the partnership representative in the course of an administrative proceeding with respect to that partnership. The notifications also apply to any proceeding with respect to an administrative adjustment request filed by a partnership. These notices are (1) notice of any administrative proceeding initiated at the partnership level; (2) notice of a proposed partnership adjustment resulting from the proceeding; and (3) notice of any final partnership adjustment resulting from the proceeding. Such notices are sufficient if mailed to the last known address of the partnership representative or the partnership, even if the partnership has terminated its existence.

A notice of proposed adjustments informs the partnership of any adjustments tentatively determined by the Secretary and the amount of any imputed underpayment resulting from such adjustments. The issuance of a notice of proposed partnership adjustment begins the running of a period of 270 days in which to supply all information required by the Secretary in support of a request for modification. During that same period, the Secretary may not issue a notice of final partnership adjustment. The Secretary is required to establish procedures and timeframes for the modification process in published guidance, which may include conditions under which extensions of time in which to submit final documentation of a modification request may be permitted by the Secretary.

With the issuance of a notice of final partnership adjustment to the partnership, a 90-day period begins during which the partnership may seek judicial review of the partnership adjustment. The issuance of a notice of final partnership adjustment also marks the beginning of the 45-day period in which the partnership may elect the alternative payment procedures. Further notices of adjustment or assessments of tax against the partnership with respect to the partnership taxable year that is the subject of the notice of final partnership adjustment are prohibited during the period in which judicial review may be sought or during which a judicial proceeding is pending (absent a showing of fraud, malfeasance, or misrepresentation of a material fact).



Any notice of partnership adjustment may be rescinded by the Secretary, if the partnership consents. If the notice is rescinded, it is a nullity, and does not confer a right to seek judicial review, nor does it bar issuance of further notices.

### **Assessment, Collection and Payment**

An imputed underpayment is assessed and collected in the same manner as if it were a tax imposed for the adjustment year under the federal income tax. The general provisions for assessment, collection and payment under subtitle F of the IRC apply unless superseded by rules of the new centralized system. As a result, an imputed underpayment may be assessed against a partnership if the partnership agrees with the results of the examination, following the expiration of the 90<sup>th</sup> day after issuance of a notice of final partnership adjustment without initiation of judicial proceedings, or in the case of timely judicial proceedings, following the entry of final decision of such proceedings. If no court proceeding is initiated within the 90-day period, the amount that may be assessed against the partnership is limited to the imputed underpayment shown in the notice.

In the case of an administrative adjustment request for which the adjustment is determined and taken into account by the partnership in the partnership taxable year in which the request is made, the imputed underpayment is required to be paid when the request is filed, and is assessed at that time. If the administrative adjustment request is subsequently audited and results in an imputed underpayment greater than that reported and paid with the originally filed request, the additional amount of the imputed underpayment may be assessed in the same manner and subject to the same restrictions as any other imputed underpayment determined after examination.

### *Restrictions on Assessment, Levy, and Collection*

The centralized system provides a limitation on the time for assessment of a deficiency as well as levy and court proceedings for collection. Except as otherwise provided, no assessment of a deficiency may be made, and no levy or court proceeding for collection of any amount resulting from an adjustment may be made, begun, or prosecuted with respect to the partnership taxable year in issue before the close of the 90<sup>th</sup> day after the day that a notice of final partnership adjustment was mailed. If a petition for judicial review is filed, no such assessment may be made and no such levy or court proceeding may be made, begun, or prosecuted before the decision of the court has become final.

A premature action (*i.e.*, one that violates the limitation on the time of assessment, levy, and court proceeding for collection) may be enjoined in the proper court, including the Tax Court. This rule applies notwithstanding the general rule prohibiting suits for the purpose of restraining the assessment or collection of any tax. The Tax Court has no jurisdiction to enjoin any such premature action unless a timely petition for judicial review has been filed, and then only in respect of the adjustments that are the subject of the petition.

Several exceptions to the restrictions on assessment are provided. First, rules similar to the math-error authority under IRC section 6213(b) are permitted as exceptions to the restrictions on assessment described above. The exceptions apply to instances in which a partnership is notified

that adjustments to its return are necessary to correct errors arising from mathematical or clerical errors and in the case of a tiered partnership that fails to prepare its partnership return consistently with that of the partnership in which it is a partner. In the case of an inconsistent return position, the rules similar to those in IRC section 6213(b) (providing for subsequent abatement of any resulting assessments if challenged within 60 days) are not applicable. Finally, a partnership may waive the restrictions on the making of any partnership adjustment.

## **Interest and Penalties**

### *Interest*

In general, interest due is determined at the partnership level and accrues at the rate applicable to underpayments. Two periods are relevant in computing the total interest due: (1) the period in which the imputed underpayment of income tax exists, and (2) the period attributable only to late payment of any imputed underpayment after notice and demand. For an imputed underpayment, interest accrues for the period from the due date of the return for the reviewed year until the due date of the adjustment year return, or, if earlier, payment of the imputed tax. If the imputed underpayment is not timely paid with the return for the adjustment year, interest is computed from the return due date for the adjustment year until payment.

If the partnership elects the alternative payment method under IRC section 6226, under which the underpayment is determined at the partner level, the interest due is computed at the partner level. The underpayment interest begins to accrue from the due date of the return for the taxable year to which the increase is attributable, at a rate two percentage points higher than the rate otherwise applicable to underpayments.

### *Penalties*

Generally, the partnership is liable for any penalty, addition to tax, or additional amount. These amounts are determined at the partnership level as if the partnership was an individual who was subject to federal income tax for the reviewed year, and the imputed underpayment was an actual underpayment or understatement for the reviewed year.

A penalty, addition to tax, or additional amount may apply with respect to an adjustment year return of a partnership in the event of late payment of an imputed underpayment, or, in the case of an election by the partnership under IRC section 6226, with respect to the adjustment year return of a partner. In such cases, the penalty for failure to pay applies. For purposes of accuracy-related and fraud penalties, the determination is made by treating the imputed underpayment as an underpayment of tax.

## **Judicial Review of Partnership Adjustment**

A partnership may seek judicial review of a notice of final partnership adjustment within 90 days after the notice is mailed. Judicial review is available in the U.S. Tax Court, the Court of Federal Claims or a U.S. District Court for the district in which the partnership has its principal place of business.

With respect to judicial review in either the Court of Federal Claims or a U.S. District Court, jurisdiction is contingent on the partnership depositing with the Secretary, on or before the date of the petition, an amount equal to the full imputed underpayment. The deposit is not treated as a payment of tax other than for purposes of determining whether interest on any underpayment as ultimately determined would be due. The proceeding is a de novo proceeding, and determinations made pursuant to the proceeding are subject to review to the same extent as any other decision, decree or judgment of the court in question.

Once a proceeding is initiated, a decision to dismiss the proceeding (other than a dismissal because the notice of final partnership adjustment was rescinded under IRC section 6231(c)), is a judgment on the merits upholding the final partnership adjustments.

### **Period of Limitations on Making Adjustments**

In general, the Secretary may adjust an item on a partnership return at any time within three years of the date a return is filed (or the return due date, if the return is not filed) or an administrative adjustment request is made. The time within which the adjustment is made by the Secretary may be later if a notice of proposed adjustment is issued, because the issuance of a notice of proposed partnership adjustment begins the running of a period of 270 days in which the partnership may seek a modification of the imputed underpayment. Although the partnership generally is limited to 270 days from the issuance of that notice to seek a modification of the imputed underpayment, extensions may be permitted by the IRS. During the 270-day period, the Secretary may not issue a notice of final partnership adjustment.

After the timely issuance of a notice of proposed adjustment resulting in an imputed underpayment, the notice of final partnership adjustment may be issued no later than either the date which is 270 days after the partnership has completed its response seeking a revision of an imputed underpayment, or, if the partnership provides an incomplete or no response, no later than 330 days after the date of a notice of proposed adjustment.<sup>833</sup>

The partnership may consent to an extension of time within which a partnership adjustment may be made. In addition, the Secretary may agree to extend the period of time in which the request for modification is submitted, under procedures to be established for submitting and reviewing requests for modification. If an extension of the time within which to seek a modification is granted, a similar period is added to the time within which the Secretary may issue a notice of final partnership adjustment. The procedures for modifications of imputed underpayments are required to provide rules that exclude from any underpayment of tax the portion of adjustments

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<sup>833</sup> See section 411 of the Protecting Americans from Tax Hikes Act of 2011, Division Q of Public Law 114-113, which rectifies the unintended conflict between IRC section 6231 (barring the Secretary from issuing the notice of final partnership adjustment earlier than the expiration of the 270 days after the notice of a proposed adjustment) and IRC section 6235 (requiring that a notice of final partnership adjustment be filed no later than 270 days after the notice of proposed adjustment in the case of a partnership that does not seek modification of the imputed underpayment). As amended, IRC section 6235 provides that a notice of final partnership adjustment to a partnership that does not seek modification of an underpayment in response to a notice of proposed adjustment may be issued up to 330 days (plus any additional number of days that were agreed upon as an extension of time for taxpayer response) after the notice of proposed adjustment.

that may have already been taken into consideration on amended returns filed by partners and for which the allocable underpayment of tax was paid.

Several exceptions similar to those generally applicable outside the context of partnerships are provided to the limitations period. In the case of a fraudulent return or failure to file a return, a partnership adjustment may be made at any time. If a partnership files a return on which it makes a substantial omission of income within the meaning of IRC section 6501(e)(1)(A), the Secretary may make adjustments to the return within six years of the date the return was filed.

In addition, if a notice of final partnership adjustment described in IRC section 6231 is mailed, the limitations period is suspended for the period during which judicial remedies under IRC section 6234 may be pursued or are pursued and for one year thereafter. Where a partnership elects to apply IRC section 6226, the provision operates to ensure that the period in which the Secretary may assess the resulting underpayment due from each partner is open for at least one year after proceedings at the partnership level have concluded. The partner who is responsible for paying an underpayment arising from the partnership reviewed year must compute such tax with respect to his taxable year in which or with which the partnership reviewed year ends, and pay the additional tax with the return for the year in which the partnership mails the statements to partners under IRC section 6226. Because the additional tax arises from an adjustment at the partnership level that is binding on the partner, the partner may neither contest the merits of the partnership adjustment, nor may the partner claim the Secretary is time barred with respect to such adjustment.

## **Definitions and Special Rules**

### *Partnership*

The term partnership means any partnership required to file a return under IRC section 6031(a). This includes any partnership described in IRC section 761 that is required to file a return.

### *Partnership Adjustment*

The term partnership adjustment means any adjustment in the amount of any item of income, gain, loss, deduction, or credit of a partnership, or any partner's distributive share thereof.

### *Return Due Date*

The term return due date means, with respect to the taxable year, the date prescribed for filing the partnership return for such taxable year (determined without regard to extensions).

### *Payments Nondeductible*

No deduction is allowed under the federal income tax for any payment required to be made by a partnership under the centralized system of partnership audit, assessment, and collection. Under the centralized system, the flow-through nature of the partnership under subchapter K of the IRC is unchanged, but the partnership is treated as a point of collection of underpayments that would otherwise be the responsibility of partners. The return filed by the partnership, though it is

an information return, is treated as if it were a tax return where necessary to implement examination, assessment, and collection of the tax due and any penalties, additions to tax, and interest.

A basis adjustment (reduction) to a partner's basis in its partnership interest is made to reflect the nondeductible payment by the partnership of the tax. Specifically, present-law IRC section 705(a)(2)(B) applies, providing that the adjusted basis of a partner's interest in a partnership is the basis of the interest determined under applicable rules relating to contributions and transfers, and decreased (but not below zero) by expenditures of the partnership that are not deductible in computing its taxable income and not properly chargeable to capital account. Concomitantly, the partnership's total adjusted basis in its assets is reduced by the cash payment of the tax.

Thus, parallel basis reductions are made to outside and inside basis to reflect the partnership's payment of the tax. Partners, former partners, and the partnership may have entered into indemnification agreements under the partnership agreement with respect to the risk of tax liability of former or new partners being borne economically by new or former partners, respectively. Because the payment of tax by a partnership under the centralized system is nondeductible, payments under an indemnification or similar agreement with respect to or arising from the tax are nondeductible.

#### *Partnerships Having Principal Place of Business Outside the United States*

For purposes of judicial review following a notice of final partnership adjustment, a principal place of business located outside the U.S. is treated as located in the District of Columbia.

#### *Suspension of Period of Limitations on Making Adjustment, Assessment or Collection*

A rule similar to the present-law rule to conform the automatic stay of the Bankruptcy Code (Title 11) with the limitations period applicable under the centralized system for partnership adjustments is included. Any statute of limitations period provided under the centralized system on making a partnership adjustment, or on assessment or collection of an imputed underpayment, is suspended during the period the Secretary is prohibited by reason of the Title 11 case from making the adjustment, assessment, or collection. For adjustment or assessment, the relevant statute of limitations is extended for 60 days thereafter. For collection, the relevant statute of limitations is extended for six months thereafter.

In a case under Title 11, the 90-day period to petition for judicial review after the mailing of the notice of final partnership adjustment is suspended during the period the partnership is prohibited by reason of the Title 11 case from filing such a petition for judicial review, and for 60 days thereafter.

#### *Treatment Where Partnership Ceases to Exist*

If a partnership ceases to exist before a partnership adjustment under the centralized system is made, the adjustment is taken into account by the former partners of the partnership, under regulations provided by the Secretary. Whether a partnership ceases to exist for this purpose is determined without regard to whether there is a technical termination of the partnership within

the meaning of IRC section 708(b)(1)(B). The successor partnership in a technical termination succeeds to the adjustment or imputed underpayment, absent regulations to the contrary. A partnership that terminates within the meaning of IRC section 708(b)(1)(A) is treated as ceasing to exist. In addition, a partnership also may be treated as ceasing to exist in other circumstances or based on other factors, under regulations provided by the Secretary. For example, for the purpose of whether a partnership ceases to exist under new IRC section 6241(7), a partnership that has no significant income, revenue, assets, or activities at the time the partnership adjustment takes effect may be treated as having ceased to exist.

#### *Extension to Entities Filing Partnership Return*

If a partnership return (Form 1065) is filed by an entity for a taxable year but it is determined that the entity is not a partnership (or that there is no entity) for the year, then, to the extent provided in regulations, the provisions of this subchapter are extended in respect of that year to the entity and its items of income, gain, loss, deduction, and credit, and to persons holding an interest in the entity.

#### **Related Rules**

##### *Binding Nature of Partnership Adjustment Proceedings*

The merits of an issue that is the subject of a final determination in a proceeding brought under the centralized system is among the issues that are precluded from being raised at a collection due process hearing (in connection with the right to, and opportunity for, such a hearing prior to a levy on any property or right to any property under present law). The authority of the Secretary to permit an opportunity for administrative review is not restricted, similar to the Collection Appeals Program, nor does it limit a partner's right to seek review of the conduct of collection measures, such as whether notices of federal tax lien or notice of intent to levy were timely issued.

##### *Restriction on Authority to Amend Partner Information Statements*

Partner information returns (currently Schedules K-1) required to be furnished by the partnership may not be amended after the due date of the partnership return to which the partner information returns relate. The due date takes into account the permitted extension period. For example, the Schedules K-1 furnished by a partnership with respect to its taxable year 2020 may not be amended after the due date for the partnership 2020 return. If the partnership has a calendar taxable year, the due date for its partnership 2020 return is September 15, 2021 (taking into account the permitted 6-month extension following the due date of March 15, 2021), after which date the Schedules K-1 for 2020 may no longer be amended. The partnership may, however, file an administrative adjustment request pursuant to new IRC section 6227, and the partnership may pay any resulting imputed underpayment at the partnership level.



New Federal Law (IRC sections 6031, 6225, 6226, 6227, 6231, 6232, 6233, 6234, 6235, 6241, 6651, 6696, 6698, 6702, 6724, 7485)

### **Amendment of Statements (Schedule K-1s) to Partners**

The provision clarifies that a partnership that has validly elected out of the partnership audit rules under IRC section 6221(b), and therefore is not subject to the partnership audit rules, may amend partner statements (Schedule K-1s) after the due date of the partnership return to which the statements relate.

### **Partnership Adjustment Tracking Report and Administrative Adjustment Request Not Treated As Amended Return**

The provision clarifies that neither the partnership adjustment tracking report required to be filed in a push-out, nor an administrative adjustment request submitted under IRC section 6227, is treated as a return for purposes of modifying an imputed underpayment of a partnership through partner amended return filings and payments under IRC section 6225(c)(2)(A). Only a partner's return satisfies the requirement under the partner amended return filing modification procedure.

### **Authority to Require E-Filing of Materials**

Authority is provided for the Secretary to require electronic filing or submission of anything that must be filed or submitted in connection with procedures for modifying the imputed underpayment amount under IRC section 6225(c). Authority is also provided for the Secretary to require electronic filing or furnishing of anything that has to be furnished to or filed with the Secretary in connection with the push-out procedures under IRC section 6226.

### **Clarification of Assessment Authority in a Push-Out**

The provision clarifies that, in the case of a partnership that has validly elected under IRC section 6226 (push-out) in the manner that the Secretary provides, no assessment of tax, levy, or proceeding in court for the collection of the imputed underpayment is to be made against the audited partnership.

### **Treatment of Partnership Adjustments that Result in Decrease in Tax in Push-Out**

As an alternative to partnership payment of the imputed underpayment in the adjustment year, the audited partnership may elect to furnish to the Secretary and to each partner of the partnership for the reviewed year a statement of the partner's share of any adjustments to partnership-related items as determined by reference to the final determination with respect to the adjustment. In this situation, IRC section 6225, requiring the audited partnership to pay the imputed underpayment, does not apply. Instead, each reviewed-year partner takes the adjustments into account for the taxable year that includes the date of the statement and pays the tax as provided in IRC section 6226 (taking into account IRC section 6226(b)(4)).



The provision specifies that account adjustments that decrease as well as increase the partner's tax are taken into account to determine a partner's tax in a push-out. The provision clarifies that in a push-out, the partner's tax for the taxable year that includes the date of the statement is adjusted by the aggregate of the correction amounts (not adjustment amounts).

The correction amount for a particular taxable year of a partner takes into account both decreases and increases. That is, the correction amount for the partner's taxable year that includes the end of the reviewed year is the amount by which the income tax would increase or decrease if the partner's share of adjustments were taken into account for that year. Similarly, the correction amount for any taxable year of the partner after that year, and before the year that includes the date of the statement, is the amount by which the income tax would increase or decrease if the partner's share of adjustments were taken into account for that year. The present-law treatment of mathematical or clerical errors applies with respect to correction amounts and aggregate correction amounts.

### **Coordination with Adjustments Related to Foreign Tax Credits**

The provision clarifies that the Secretary is to issue regulations or other guidance providing for the proper coordination of IRC section 6227, relating to administrative adjustment requests by the partnership, with the rule of IRC section 905(c), relating to foreign tax credits and redetermination of the amount of tax in certain circumstances.

### **Clarification of Assessment of Imputed Underpayments**

The provision clarifies that the assessment of any imputed underpayment is not subject to the deficiency procedures of subchapter B of chapter 63. Rather, they are assessed and collected in accordance with the rules of subchapter C of chapter 63. Any imputed underpayment (including an imputed underpayment under IRC section 6226(b)(4)(A)(ii) of a partnership or S corporation that is a direct or indirect partner of an audited partnership in a push-out) is assessable under the provision.

The provision clarifies that in the case of an administrative adjustment request to which IRC section 6227(b)(1) applies, the underpayment must be paid, and may be assessed, when the request is filed.

A reference in IRC section 6232(b) to the assessment of a deficiency is corrected to refer to the assessment of an imputed underpayment. Generally, then, an imputed underpayment of a partnership may not be assessed or collected before the close of the 90<sup>th</sup> day after the day on which a notice of final partnership adjustment was mailed, and if a petition is filed under IRC section 6234 with respect to the notice, the decision of the court has become final.

However, the restrictions on assessment and collection of an imputed underpayment provided generally under IRC section 6232(b) do not apply in the case of any specified similar amount within the meaning of IRC section 6232(f)(2). As a result, the restrictions do not apply to the imputed underpayment of a partner that is a partnership or S corporation in a push-out. A specified similar amount means the amount described in IRC section 6226(b)(4)(A)(ii)(II), including a failure to furnish statements to partners or S corporation shareholders treated as a

failure to pay that amount under IRC section 6651(i). A specified similar amount also means any amount assessed on a partner that is a partnership or S corporation. Thus, for example, these restrictions do not apply to assessment and collection of an imputed underpayment of a partnership or S corporation that receives a statement in a push-out and neither timely furnishes statements to its partners or shareholders nor pays its imputed underpayment.

#### **Time Limit for Notice of Proposed Partnership Adjustment**

The provision clarifies that a notice of proposed partnership adjustment must be mailed within the applicable period of limitations on making adjustments under the partnership audit rules (subchapter C of chapter 63 of the IRC). The notice of proposed partnership adjustment cannot be relied upon to revive an otherwise expired limitations period under IRC section 6235. For purposes of determining whether or not a notice of proposed partnership adjustment is timely, the applicable limitations period is determined under IRC section 6235, determined without regard to IRC section 6235(a)(2) (relating to the period for modification of an imputed underpayment under IRC section 6225(c)(7)), and without regard to IRC section 6235(a)(3) (relating to the 330-day period (or the period as extended) for making an adjustment after the date of a notice of proposed partnership adjustment).

The provision does not alter the IRC section 6231(b)(2) prohibition against mailing any notice of final partnership adjustment earlier than 270 days after the date on which the notice of proposed partnership adjustment is mailed (except to the extent the partnership elects to waive the prohibition).

#### **Deposit to Suspend Interest on Imputed Underpayment**

The provision clarifies that, before the due date for payment of an imputed underpayment, a partnership (or, in the case of a partner payment pursuant to an election under IRC section 6226, a partner) may make a cash deposit to suspend the running of interest as provided under present-law rules in IRC section 6603. The deposit is not treated as a tax payment.

#### **Deposit to Meet Jurisdictional Requirement**

The provision clarifies that the amount of the jurisdictional deposit that the partnership must make in order to file a readjustment petition in court is the amount of (as of the date of the filing of the petition) the imputed underpayment, penalties, additions to tax, and additional amounts with respect to the imputed underpayment (not just the imputed underpayment amount).

#### **Period of Limitations on Making Adjustments**

The provision clarifies several rules relating to the period of limitations on making adjustments. The provision makes clear that the period of limitations on making adjustments under subchapter C of chapter 63 does not limit the period for notification of the Secretary and redetermination of tax under IRC section 905(c). The provision corrects a cross reference so that it refers to subchapter C of chapter 63 (rather than to a nonexistent subpart). The provision clarifies a reference to the penalty for substantial omission of income to incorporate a reference to constructive dividends, not just to other omitted items. The provision clarifies that the time for

making any adjustment under subchapter C of chapter 63 with respect to any tax return, event, or period does not expire before the date determined under IRC section 6501(c)(8) (relating to the failure to notify the Secretary of certain foreign transfers), that is, generally, the date that is three years after the date on which the Secretary is furnished the information required to be reported. The provision clarifies that the time for making any adjustment under subchapter C of chapter 63 with respect to a listed transaction described in IRC section 6501(c)(10) does not expire on the date determined under IRC section 6501(c)(10), that is, generally, the date that is one year after the earlier of the date on which the Secretary is furnished the information required to be reported or the date on which a material advisor meets certain applicable requirements. The provision is clarified by striking IRC section 6235(d), a provision included in prior law that has no effect under subchapter C of chapter 63.

### **Treatment of Special Enforcement Matters**

The provision provides regulatory authority similar to that under the prior-law TEFRA partnership audit rules. It provides that in the case of partnership-related items involving special enforcement matters, the Secretary may prescribe guidance under which the partnership audit rules (or any portion of the rules) do not apply, and the special enforcement items are subject to special rules, including rules related to assessment and collection that are needed for effective and efficient enforcement. Special enforcement matters mean: failure to comply with the requirements of IRC section 6226(b)(4)(A)(ii) to pay the imputed underpayment if the requirement to furnish statements has not been satisfied, termination and jeopardy assessments, criminal investigations, indirect methods of proof of income, foreign partners or partnerships, and other matters presenting special enforcement considerations.

### **United States Shareholders and Certain Other Persons Treated as Partners**

The provision clarifies the treatment under the rules of subchapter C of chapter 63 of U.S. shareholders and certain other persons treated as partners. Except as otherwise provided in guidance promulgated by the Secretary, in the case of a controlled foreign corporation (defined in IRC section 957 or 953(c)(1)) that is a partner of a partnership, each U.S. shareholder is treated under subchapter C of chapter 63 as a partner in the partnership. For this purpose, except as otherwise provided by the Secretary, the distributive share with respect to the partnership equals the U.S. shareholder's pro rata share with respect to the controlled foreign corporation, determined under rules similar to the rules for determining its pro rata share of subpart F income under IRC section 951(a)(2).

The provision also makes clear the treatment under subchapter C of chapter 63 of a passive foreign investment company (PFIC) that is a partner in a partnership and that is a qualified electing fund with respect to a taxpayer pursuant to the taxpayer's election under IRC section 1295. In the case of such a taxpayer, for purposes of the foregoing rule treating the taxpayer as a partner in the partnership, the taxpayer's distributive share with respect to the partnership equals the taxpayer's pro rata share with respect to the PFIC, determined under rules similar to the rules for determining the taxpayer's pro rata share under IRC section 1293(b) (relating to pro rata share for purposes of current taxation of income from qualified electing funds).

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Under the provision, authority for Treas. Reg. or other guidance is provided as is necessary or appropriate to carry out the legislative purpose or to apply the rule treating persons as partners in similar circumstances or with respect to similarly situated persons.

**Penalties Relating to Administrative Adjustment Requests and Partnership Adjustment Tracking Reports**

The provision clarifies existing penalty provisions to ensure that they address compliance with the partnership audit rules. A partnership adjustment tracking report required to be filed pursuant to an IRC section 6226 election is treated as a return for purposes of penalties relating to failure to file a partnership return, frivolous position submissions, and preparation of tax returns for other persons. A failure to comply with IRC section 6226(b)(4)(A)(ii)(II), relating to the requirement to furnish statements in a push-out, is treated as a failure to pay an imputed underpayment for purposes of the penalty relating to failure to file a tax return or to pay tax. An administrative adjustment request under IRC section 6227 is treated as a return for purposes of penalties relating to frivolous position submissions and the preparation of tax returns for other persons. Section 206(b) of Division U of the amendment, however, clarifies that neither an administrative adjustment request under IRC section 6627 nor a partnership adjustment tracking report under IRC section 6226(b)(4)(A) is treated as a return for purposes of the partner amended return modification procedure of IRC section 6225(c)(2)(A).

**Statements to Partners (Adjusted Schedules K-1) Treated as Payee Statements**

The provision clarifies that for purposes of the penalty for failure to furnish correct payee statements and the penalty for failure to file correct information returns, statements required to be furnished to partners in a push-out under IRC section 6226(a)(2), or statements required to be furnished to partners under rules similar to IRC section 6226(a)(2), are treated as payee statements.

Statements required to be furnished to partners under rules similar to IRC section 6226(a)(2) include statements furnished to partners pursuant to an administrative adjustment request under IRC section 6227.

**Clerical Corrections Relating to Partnership Audit Rules**

The provisions make clerical corrections to the partnership audit rules.

Effective Date

The amendments made by Title II of this Act shall take effect as if included in section 1101 of the BBA of 2015.

California Law (R&TC sections 18535, 18621.5, 18622.5, 18633, 18633.5, 19001, 19033, 19041.5, 19058, 19101-19120, 19137-19187, 25116, and 25128)

## **In General**

For purposes of reporting federal audit adjustments and administrative adjustment requests to the state, California has modified conformity<sup>834</sup>, under the AFITL, to the new federal centralized system for audit, adjustment and assessment of tax for partnerships as in effect January 1, 2018. These federal rules are effective for returns filed for taxable years beginning after December 31, 2017, but include an election to apply the rules to any return filed for taxable years beginning after November 2, 2015.<sup>835</sup>

## **Amendment of Statements (Schedule K-1s) to Partners**

California does not conform to the federal provision relating to the amendment of Schedule K-1 statements to partners, and instead has stand-alone rules for the filing of Schedule K-1 statements.<sup>836</sup>

## **Partnership Adjustment Tracking Report and Administrative Adjustment Request Not Treated As Amended Return**

California does not conform to the federal provision relating to certain federal reports not treated as an amended return, and instead has stand-alone rules for the reporting and filing of federal adjustments to partnerships and partners.<sup>837</sup>

## **Authority to Require E-Filing of Materials**

California does not conform to the federal provision requiring electronic filing or submission relating to modification of the imputed underpayment amount and in connection with the push-out procedures, and instead has stand-alone law relating to partnership electronic filing requirements.<sup>838</sup>

## **Clarification of Assessment Authority in a Push-Out**

California does not conform to the federal provision which provides that, in the case of a partnership that has validly elected under IRC section 6226 (push-out) in the manner that the Secretary provides, no assessment of tax, levy, or proceeding in court for the collection of the imputed underpayment is to be made against the audited partnership.

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<sup>834</sup> R&TC section 18622.5.

<sup>835</sup> Enactment date of the BBA of 2015, Public Law 114-74.

<sup>836</sup> R&TC sections 18633 and 18633.5.

<sup>837</sup> R&TC sections 18622 and 18622.5.

<sup>838</sup> R&TC section 18621.5.

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California has a stand-alone provision that requires partnerships that have validly elected a federal or state push-out, to file an amended nonresident group return<sup>839</sup> for all nonresident direct partners and pay the additional tax that would have been due had all the federal adjustments been reported. For any partners not included in the amended nonresident group return, the adjustments to the partner's share of partnership items must be reported by each such partner.<sup>840</sup>

#### **Treatment of Partnership Adjustments that Result in Decrease in Tax in Push-Out**

California does not conform to the federal provision relating to the treatment of partnership adjustments that result in a decrease in tax in a push-out. California has a stand-alone provision that requires partnerships that have validly elected a federal or state push-out, to file an amended nonresident group return<sup>841</sup> for all nonresident direct partners and pay the additional tax that would have been due had all the federal adjustments been reported. For any partners not included in the amended nonresident group return, the adjustments to the partner's share of partnership items must be reported by each such partner.<sup>842</sup>

#### **Coordination with Adjustments Related to Foreign Tax Credits**

California does not conform to federal foreign tax credits.<sup>843</sup> As a result, California does not conform to the federal provision allowing coordination with partnership adjustments relating to foreign tax credits.

#### **Clarification of Assessment of Imputed Underpayments**

California has stand-alone law relating to the assessment of tax on partnerships for federal audit adjustments and administrative adjustment requests,<sup>844</sup> and does not conform to the federal clarification relating to the assessment of imputed underpayments.

#### **Time Limit for Notice of Proposed Partnership Adjustment**

California has stand-alone law relating to timeframes for issuance of a notice of proposed assessment of partnership tax for federal audit adjustments and administrative adjustment requests,<sup>845</sup> and does not conform to the federal clarification of the time limit for issuing a notice of proposed partnership adjustment.

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<sup>839</sup> Under R&TC section 18535.

<sup>840</sup> R&TC section 18622.5(d)(2).

<sup>841</sup> Under R&TC section 18535.

<sup>842</sup> R&TC section 18622.5(d)(2).

<sup>843</sup> IRC section 905.

<sup>844</sup> R&TC section 18622.5(d).

<sup>845</sup> R&TC section 18622.5(f).

### **Deposit to Suspend Interest on Imputed Underpayment**

California conforms, with modifications, under the AFITL, to the federal law relating to deposits made to stop the running of interest,<sup>846</sup> as of the specified date of January 1, 2015,<sup>847</sup> but does not specifically conform to the federal provision clarifying that a partnership or partner<sup>848</sup> may make a cash deposit to suspend the running of interest, which is not treated as a tax payment for purposes of a partnership imputed underpayment.<sup>849</sup>

California has stand-alone law which provides that a deposit in the nature of a “cash bond” can be made to stop the running of interest on a deficiency assessment.<sup>850</sup> Such payments are not considered a “payment of tax” for purposes of filing a claim for refund or bringing an action until either (1) the taxpayer provides a written statement to the FTB specifying that the deposit shall be a payment of tax, or (2) the deficiency assessed is final, the FTB has issued a notice and demand, and the deficiency assessed is due and payable.

As a result, a cash deposit may be made to stop the running of interest on a California partnership or partner deficiency assessment.

### **Deposit to Meet Jurisdictional Requirement**

California does not conform to the federal provision relating to a deposit to meet the jurisdictional requirement for bringing action in district court or the Court of Federal Claims, and does not conform to the federal clarification of this provision.

### **Period of Limitations on Making Adjustments**

The provision clarifies several rules relating to the period of limitations on making adjustments. California law is discussed for each provision below.

- 1) California does not conform to federal foreign tax credits or to the federal provision clarifying that the period of limitations on making adjustments under subchapter C of chapter 63 does not limit the period for notification of the Secretary and redetermination of tax under IRC section 905(c).
- 2) California does not conform to the provision that corrects a cross reference so that it refers to subchapter C of chapter 63 (rather than to a nonexistent subpart).
- 3) California does not conform to the federal law relating to the period of limitations on (i) making partnership adjustments, or (ii) the substantial omission of income, and does not conform to the provision that clarifies a reference to the penalty for substantial omission of income to incorporate a reference to constructive dividends, not just to other omitted items. California has stand-alone language relating to reporting federal partnership audit adjustment and for the statute of limitations related to the substantial omission of

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<sup>846</sup> IRC section 6603.

<sup>847</sup> R&TC sections 18402, 17024.5, and 23051.5.

<sup>848</sup> IRC section 6226.

<sup>849</sup> IRC section 6233.

<sup>850</sup> R&TC section 19041.5.



income.<sup>851</sup>

- 4) California does not conform to the federal law relating to the period of limitations on making partnership adjustments or to the limitations on assessment and collection relating to failure to notify the IRS of certain foreign transfers, and does not conform to the provision that clarifies that the time for making any adjustment under subchapter C of chapter 63 of the IRC with respect to any tax return, event, or period does not expire before the date determined under IRC section 6501(c)(8) (relating to the failure to notify the Secretary of certain foreign transfers). California has stand-alone language relating to reporting federal partnership adjustments and does not require notification of certain foreign transfers.<sup>852</sup>
- 5) California does not conform to the federal law relating to the period of limitations on making partnership adjustments or to the limitations on assessment and collection. Under the AFITL, California has modified conformity to the federal provision related to “listed transactions”, as of the specified date of January 1, 2015,<sup>853</sup> but does not conform to the federal provision that clarifies the time for making any adjustment under subchapter C of chapter 63 with respect to a listed transaction described in IRC section 6501(c)(10).
- 6) California does not conform to the federal law relating to the period of limitations on making partnership adjustments or to the limitations on assessment and collection, or the provision that strikes IRC section 6235(d), a provision included in prior law that has no effect under subchapter C of chapter 63.

### **Treatment of Special Enforcement Matters**

California has stand-alone law relating to the assessment of tax on partnerships for federal audit adjustments and administrative adjustment requests,<sup>854</sup> and does not conform to the federal change providing regulatory authority for partnership-related items involving special enforcement matters.

### **United States Shareholders and Certain Other Persons Treated as Partners**

California does not conform to subpart F (sections 951 to 965) of the IRC, relating to controlled foreign corporations (CFCs), 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

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<sup>851</sup> R&TC sections 18622.5(a) and 19058.

<sup>852</sup> R&TC section 18622.5(a).

<sup>853</sup> R&TC sections 18402, 17024.5, and 23051.5.

<sup>854</sup> R&TC section 18622.5(d).

activity in the state by using the amount of the taxpayer's sales in California divided by the taxpayer's sales everywhere.<sup>855</sup> 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 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.<sup>856</sup>

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 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.

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 (PFIC), are specifically not applicable for California purposes.

California does not conform to the definitions and special rules under IRC section 6241, and does not conform to the federal changes that clarify the treatment of U.S. shareholders relating to CFCs and PFICs.

#### **Penalties Relating to Administrative Adjustment Requests and Partnership Adjustment Tracking Reports**

California does not conform to the federal clarification which applies to various filing penalties relating to a partnership that has made a valid election under IRC section 6226 (push-out), or filed an administrative adjustment request.

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<sup>855</sup> 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.)

<sup>856</sup> 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.

### Statements to Partners (Adjusted Schedules K-1) Treated as Payee Statements

California has modified conformity, under the AFITL, to IRC section 6724 relating to waiver; definitions and special rules, as of the specified date of January 1, 2015,<sup>857</sup> but does not conform to the federal provision which treats adjusted schedules K-1 as payee statements.

### Clerical Corrections Relating to Partnership Audit Rules

California does not conform to various clerical corrections relating to the partnership audit rules.<sup>858</sup>

### Impact on California Revenue

Not applicable.

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## Division U, Title III—Other Corrections

<u>Section</u>	<u>Section Title</u>
301	Amendments Relating to the Bipartisan Budget Act of 2015

### Background

Present law requires that a person may be required to file returns electronically if the person is required to file at least 250 returns during the calendar year. For purposes of determining the 250-return threshold, returns filed within one calendar year by a corporation include any type, including information returns (for example, Forms W-2, Forms 1099), income tax returns, employment tax returns, and excise tax returns. However, partnerships having more than 100 partners are required to file returns electronically.

### New Federal Law (IRC section 6011)

### Electronic Filing of Partnership Returns

For partnerships only, the provision phases in reductions in the number of returns and statements during a calendar year that can subject the partnership to a regulatory requirement to file returns electronically. Specifically, the provision provides that under regulations, partnerships are required to file returns electronically if the partnership is required to file at least 200 returns for calendar year 2018, 150 returns for calendar year 2019, 100 returns for calendar year 2020, 50 returns for calendar year 2021, and 20 returns for calendar years after 2021.

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<sup>857</sup> R&TC sections 18402, 17024.5, and 23051.5.

<sup>858</sup> IRC sections 6225(c)(7); 6227(b) and (b)(1); 6232(b), (d)(1)(A), and (e); 6241(5); and 7485(b).

Consolidated Appropriations Act, 2018  
Public Law 115-141, March 23, 2018

Effective Dates

The amendments made by this section shall take effect as if included in section 1101 of the BBA of 2015.

California Law (R&TC sections 18407 and 18409)

California generally conforms to IRC section 6011, relating to general requirement of return, statement, or list, as of the “specified date” of January 1, 2015,<sup>859</sup> and has stand-alone state law requiring the FTB to prescribe regulations providing standards for determining which returns are required to be filed on magnetic media (or in other machine-readable forms), and such standards apply to taxpayers required to file returns on magnetic media (or in other machine-readable forms) to the IRS as of the “specified date” of January 1, 2015.<sup>860</sup> However, California does not conform to the federal change which phases in reductions in the number of returns and statements during a calendar year that subjects a partnership to a regulatory requirement to file returns electronically.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
302	Amendments Relating to the Energy Policy Act of 2005

Background

A provision of the federal MACRS depreciation rules, originally enacted in 1986 (IRC section 168(e)(3)(B)(vi)(II)), refers to a provision of the Federal Power Act, as then in effect, defining a “qualifying small power production facility” as a facility that is “small” (power production capacity not greater than 80 megawatts) and not owned by an electric utility (as determined by Federal Energy Regulatory Commission (FERC)). The ownership limitation was repealed by the Energy Policy Act of 2005 (the 2005 Act). Since that 2005 repeal, the determination is made by relying on FERC to determine whether a facility was a “qualifying small power production facility” as that term was defined prior to the 2005 Act, a determination no longer relevant to FERC (see, e.g., IRC Private Letter Ruling 201539024).

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<sup>859</sup> For taxable years beginning on or after January 1, 2015, R&TC section 18407 conforms to IRC section 6011, relating to general requirement of return, statement, or list, as of the “specified date” of January 1, 2015, with modifications.

<sup>860</sup> R&TC section 18409.

New Federal Law (IRC section 168)

**Qualifying Small Power Production Facility**

The provision adds to the IRC the language of FERC's definition of a qualifying small power production facility (retaining the power production capacity not greater than 80 megawatts) without the electric utility ownership prohibition. The effect of the provision is that such a power production facility is 5-year property for purposes of IRC section 168(e)(3)(B)(vi)(II), not 15-year property.

Effective Dates

The provision is operative for property placed in service after the date of enactment, February 9, 2018.

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,<sup>861</sup> with modifications,<sup>862</sup> but does not conform to the federal change which treats qualifying small power production facilities as 5-year property.

California does not conform, under the CTL, to IRC section 168, relating to MACRS depreciation prior to the amendment made under the Act.

Impact on California Revenue

Negligible.<sup>863</sup>

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**Division U, Title IV—Clerical Corrections and Deadwood**

<u>Section</u>	<u>Section Title</u>
401	Clerical Corrections and Deadwood-Related Provisions

**Clerical Corrections**

The Act includes 352 clerical corrections to the IRC that are effective upon enactment.

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<sup>861</sup> R&TC section 17024.5.

<sup>862</sup> R&TC section 17250.

<sup>863</sup> Negligible revenue gain.

## Deadwood Provisions

A number of provisions in the IRC are not used in computing current taxes and thus are obsolete. These provisions are referred to as “deadwood.” The provision repeals 23 sections of the IRC and repeals or amends portions of more than 70 other sections of the IRC to remove deadwood. The provision does not change substantive law.

The amendments relating to deadwood made by the provision are operative on the date of enactment.

The provision includes savings clauses to mitigate the effects of repealing the deadwood items in the event those items have any remaining applicability to past transactions. For example, if a transfer of property took place before the date of enactment, the basis of the property is not changed by reason of any provision of the Act that amends an IRC section relating to the determination of basis.

### Impact on California Revenue

Not applicable.

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SUPPORT for Patients and Communities Act  
Public Law 115-271, October 24, 2018

**Title IV-Offsets**

<u>Section</u>	<u>Section Title</u>
4003	Additional Religious Exemption from Health Coverage Responsibility Requirement

Background

Under the Patient Protection and Affordable Care Act<sup>864</sup> (also called the Affordable Care Act, or ACA), individuals must be covered by a health plan that provides at least minimum essential 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”).<sup>865</sup> Minimum essential coverage includes government-sponsored programs (including Medicare, Medicaid, and Children’s Health Insurance Program (CHIP), among others), eligible employer-sponsored plans, plans in the individual market, grandfathered group health plans, 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.<sup>866</sup> The tax is imposed for any month that an individual lacks minimum essential coverage unless the individual qualifies for an exemption for that month.

Absent an exemption, 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 or (2) 300 percent of the adult individual dollar amount. The adult individual annual dollar amount is \$695 for 2017 and 2018.<sup>867</sup> 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.<sup>868</sup> 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<sup>869</sup>) that year.

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<sup>864</sup> Pubic Law Number 111-148.

<sup>865</sup> 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.

<sup>866</sup> 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.

<sup>867</sup> For years after 2016, the \$695 amount is indexed to CPI-U, rounded to the next lowest multiple of \$50.

<sup>868</sup> IRC section 6012(a).

<sup>869</sup> IRC section 5000A(f)(1)(C).



SUPPORT for Patients and Communities Act  
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Effective with respect to health coverage status for months beginning after December 31, 2018, the tax (also referred to as a penalty) for failure to maintain minimum essential coverage is reduced to zero.

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 percent of household income<sup>870</sup>, (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.<sup>871</sup>

### *Religious Exemptions*

The ACA provides a religious conscience exemption and a health care sharing ministry exemption from the requirement to maintain minimum essential coverage.

Under the religious conscience exemption, an individual will be exempt from the requirement to maintain minimum essential coverage for any month the individual has in effect an exemption under section 1311(d)(4)(H) of the ACA, which certifies that the individual is a member of a recognized religious sect, or a division of a recognized religious sect, described in IRC section 1402(g)(1), relating to exemption from self-employment taxes for members of certain religious faiths, and an adherent of established tenets or teachings of that sect or division.<sup>872</sup>

Under the health care sharing ministry exemption, an individual will be exempt from the requirement to maintain minimum essential coverage for any month in which the individual is a member of a health care sharing ministry (HCSM).<sup>873</sup>

A health care sharing ministry is defined as an organization:

- Which is described in IRC section 501(c)(3) and is tax-exempt under IRC section 501(a),
- The members of which share a common set of ethical or religious beliefs and share medical expenses among members in accordance with those beliefs, and without regard to the state in which a member resides or is employed,
- The members of which retain membership even after they develop a medical condition,

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<sup>870</sup> For 2017. The rate applicable for 2018 is 8.06 percent of household income.

<sup>871</sup> In addition, certain individuals present or residing outside of the U.S. and bona fide residents of U.S. territories are deemed to maintain minimum essential coverage.

<sup>872</sup> IRC section 5000A(d)(2)(A).

<sup>873</sup> IRC section 5000A(d)(2)(B)(i).

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- Which (or a predecessor of which) has been in existence at all times since December 31, 1999, and medical expenses of its members have been shared continuously and without interruption since at least December 31, 1999, and
- Which conducts an annual audit which is performed by an independent certified public accounting firm in accordance with generally accepted accounting principles and which is made available to the public on request.<sup>874</sup>

New Federal Law (IRC section 5000A)

The provision modifies the religious exemption to allow an individual to be exempt from the requirement to maintain minimum essential coverage if the individual is a member of a religious sect or division which is not described in IRC section 1402(g)(1), who relies solely on a religious method of healing, and for whom the acceptance of medical health services would be inconsistent with their religious beliefs, and who provides an attestation that the individual has not received medical health services during the preceding tax year.

The provision excludes from the definition of medical health services routine dental, vision and hearing services, midwifery services, vaccinations, necessary medical services provided to children, services required by law or by a third party, and such other services as may be provided in implementing section 1311(d)(4)(H) of the ACA.<sup>875</sup>

Effective Dates

The provision applies to taxable years beginning after December 31, 2018.

California Law (None)

The FTB currently does not administer these types of excise taxes (also referred as a penalty).

Impact on California Revenue

The FTB does not administer these types of excise taxes (also referred as a penalty).

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<sup>874</sup> IRC section 5000A(d)(2)(B)(ii).

<sup>875</sup> IRC section 5000A(d)(2)(A)(ii)(I).

Veterans Benefits and Transition Act of 2018  
Public Law 115-407, December 31, 2018

<u>Section</u>	<u>Section Title</u>
302	Residence of Spouses of Servicemembers for Tax Purposes

Background

Under United States Code (U.S.C.) section 4001, Residence for Tax Purposes, a servicemember does not lose or acquire residence or domicile, for purposes of income taxes and personal property taxes, based on the fact that the servicemember is absent from or present in any tax jurisdiction of the U.S. solely in compliance with military orders.<sup>876</sup> Thus under 4001, a servicemember that is ordered to a duty location in a new state will not be required to pay income taxes on his or her military income in a state other than the one he or she has declared as his or her home state.

A servicemember's family members may also be subject to the income tax laws in effect in the duty state. For example, the spouse of a servicemember (military spouse) that moves around the country with the servicemember and works in the various duty states has the potential financial burden of being required to file tax returns in multiple jurisdictions. To allow the income of a military spouse to be protected as well, section 511 of the Military Spouse Residency Relief Act (MSRRA),<sup>877</sup> amended U.S.C. section 4001, for purposes of income taxes, to provide the same protection so a military spouse would not be deemed to have lost or acquired domicile or residence by reason of being absent from or present in a tax jurisdiction solely to be with their servicemember-spouse, who is in compliance with military orders and has the same original residence or domicile as the military spouse.

In addition, income for services performed by the military spouse would not be deemed to be income in a tax jurisdiction where the military spouse is located solely to be with the servicemember, who is serving there in compliance with military orders.

New Federal Law (U.S.C. Section 4001)

The provision amends U.S.C. section 4001 to provide that for purposes of tax residency, for any taxable year of the marriage of a servicemember and a spouse, the military spouse of a servicemember may elect to use the same residence for purposes of taxation as the servicemember regardless of the date on which the marriage of the military spouse and the servicemember occurred.

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<sup>876</sup> Title 50, War and National Defense, Chapter 50, Servicemembers Civil Relief, Subchapter V, Taxes and Public Lands, Relating to Section 4001, Residence for Tax Purposes.

<sup>877</sup> Public Law 111-97, Military Spouse Residency Relief Act, S. 475, enacted November 11, 2009.

Veterans Benefits and Transition Act of 2018  
Public Law 115-407, December 31, 2018

Effective Dates

The provision applies to any return of state or local income tax filed for any taxable year beginning with the taxable year that includes December 31, 2018.

California Law (R&TC sections 17041, 17140.5, and 17951)

The provisions of U.S.C. section 4001 apply to California without regard to a “specified date.” Thus, any changes made to the section automatically apply to California.

Impact on California Revenue

Baseline.

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**EXHIBIT A – 2018 MISCELLANEOUS FEDERAL ACTS IMPACTING THE IRC  
NOT REQUIRING A CALIFORNIA RESPONSE**

Public Law 115-141, Consolidated Appropriations Act, 2018.

Public Law 115-141, the Consolidated Appropriations Act, 2018, is cited as the “Tax Technical Corrections Act of 2018”. It modifies the qualified business income deduction for a cooperative and its patrons, the low-income housing credit, and resolves deadwood within the IRC. In addition, the public law amends the IRC to make technical corrections related to the partnership audit rules and numerous acts, e.g., the Protecting Americans from Tax Hikes Act of 2015 (PATH Act); the Consolidated Appropriations Act, 2016; the Fixing America’s Surface Transportation Act; the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015, the Stephen Beck, Jr., ABLE Act of 2014; the American Taxpayer Relief Act of 2012; and the American Jobs Creation Act of 2004.

IRC Section	Public Law No.	Act Section No. of Division M	132 Stat. Page
4081	115-141	202	1048, 1049
4083	115-141	202	1048, 1049
4261	115-141	202	1048, 1049
4271	115-141	202	1048, 1049
9502	115-141	201	1048, 1049
		Act Section No. of Division U	
Uncodified	115-141	107	1171
Uncodified	115-141	108	1171

**EXHIBIT B – EXPIRING TAX PROVISIONS OF THE CALIFORNIA REVENUE AND TAXATION CODE**

<b>California Sunset<sup>878</sup></b>	<b>California Sections</b>	<b>Federal Section</b>	<b>Federal Sunset</b>	<b>Description</b>
06/30/19	24330	N/A	N/A	Exclusion of Income Received from - Qualified Health Care Service Plan
12/31/19	17144.7	N/A	N/A	Student Loan Forgiveness Debt Relief
06/30/20	17053.30 & 23630	N/A	N/A	Natural Heritage Preservation Credit
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
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
12/31/21	18895– 18898	N/A	N/A	Voluntary Contribution: School Supplies for Homeless Children 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

<sup>878</sup> 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.

**EXHIBIT B – EXPIRING TAX PROVISIONS OF THE CALIFORNIA REVENUE AND TAXATION CODE**

<b>California Sunset</b>	<b>California Section</b>	<b>Federal Section</b>	<b>Federal Sunset</b>	<b>Description</b>
12/31/22	18781-18784	N/A	N/A	Voluntary Contribution: Type 1 Diabetes Research 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	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
12/31/24	18791 - 18796	N/A	N/A	Voluntary Contribution: California Breast Cancer Research Voluntary Tax Contribution Fund
12/31/24	18416.5	N/A	N/A	Allow Electronic Communication to Taxpayers to Inform of Tax Change
12/31/24	18761 - 18766	N/A	N/A	Voluntary Contribution: California Alzheimer’s Disease and Related Dementia Research Voluntary Tax Contribution Fund
12/31/25	17053.73 & 23626	N/A	N/A	New Employment Credit <sup>879</sup>

<sup>879</sup> The new employment credit law sections (R&TC sections 17053.73 and 23626) are repealed on December 1, 2029. Those law sections generally apply to taxable years beginning on or after January 1, 2014, and before January 1, 2026; however, they continue to be operative for taxable years beginning on or after January 1, 2026, 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, 2026.



**EXHIBIT B – EXPIRING TAX PROVISIONS OF THE CALIFORNIA REVENUE AND TAXATION CODE**

<b>California Sunset</b>	<b>California Section</b>	<b>Federal Section</b>	<b>Federal Sunset</b>	<b>Description</b>
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
12/31/25	18907- 18907.4	N/A	N/A	Voluntary Contribution: Organ and Tissue Donor Registry Voluntary Tax Contribution Fund
12/31/25	18910- 18913	N/A	N/A	Voluntary Contribution: Schools Not Prisons Voluntary Tax Contribution Fund
12/31/25	18857- 18857.3	N/A	N/A	Voluntary Contributions: National Alliance on Mental Illness California Voluntary Tax Contribution Fund
12/31/29	17059.2 & 23689	N/A	N/A	California Competes Tax Credit
12/31/30	23636	N/A	N/A	New Advanced Strategic Aircraft Credit

**EXHIBIT C – REVENUE TABLES<sup>880</sup>**

**Assumed Enactment after June 30, 2019**

<b>Table 1 – Federal Register Printing Savings Act of 2017</b> (Public Law 115-120)					
<b>Act Section</b>	<b>Provision</b>	<b>2018-19</b>	<b>2019-20</b>	<b>2020-21</b>	<b>2021-22</b>
4001	Extension of Moratorium on Medical Device Excise Tax	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.
4002	Delay in Implementation of Excise Tax on High Cost Employer-Sponsored Health 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.
4003	Suspension of Annual Fee on Health Insurance Providers	N/A	N/A	N/A	N/A

<b>Table 2 – Bipartisan Budget Act of 2018</b> (Public Law 115-123)					
<b>Act Section</b>	<b>Provision</b>	<b>2018-19</b>	<b>2019-20</b>	<b>2020-21</b>	<b>2021-22</b>
20101	Definitions	N/A	N/A	N/A	N/A
20102	Special Disaster-Related Rules for Use of Retirement Funds	Baseline	Baseline	Baseline	Baseline
20103	Employee Retention Credit for Employers Affected by California Wildfires	N/A	N/A	N/A	N/A
20104	Additional Disaster-Related Tax Relief Provisions	N/A	N/A	N/A	N/A
20201	Tax Relief for Hurricanes Harvey, Irma, and Maria	Baseline	Baseline	Baseline	Baseline
40201	Extension and Modification of Exclusion from Gross Income of Discharge of Qualified Principal Indebtedness	- \$40,000,000	- \$17,000,000	\$0	\$0
40202	Extension of Mortgage Insurance Premiums Treated as Qualified Residence Interest	N/A	N/A	N/A	N/A

<sup>880</sup> These estimates do not consider the net final payment method of accrual for personal income taxpayers.

**EXHIBIT C - REVENUE TABLES**

<b>Act Section</b>	<b>Provision</b>	<b>2018-19</b>	<b>2019-20</b>	<b>2020-21</b>	<b>2021-22</b>
40203	Extension of Above-the-Line Deduction for Qualified Tuition and Related Expenses	N/A	N/A	N/A	N/A
40301	Extension of Indian Employment Tax Credit	N/A	N/A	N/A	N/A
40302	Extension and Modification of Railroad Track Maintenance Credit	N/A	N/A	N/A	N/A
40303	Extension of Mine Rescue Team Training Credit	N/A	N/A	N/A	N/A
40304	Extension of Classification of Certain Race Horses as 3-Year Property	N/A	N/A	N/A	N/A
40305	Extension of 7-Year Recovery Period for Motorsports Entertainment Complexes	N/A	N/A	N/A	N/A
40306	Extension and Modification of Accelerated Depreciation for Business Property on an Indian Reservation	N/A	N/A	N/A	N/A
40307	Extension of Election to Expense Mine Safety Equipment	N/A	N/A	N/A	N/A
40308	Extension of Special Expensing Rules for Certain Productions	N/A	N/A	N/A	N/A
40309	Extension of Deduction Allowable with Respect to Income Attributable to Domestic Production Activities in Puerto Rico	N/A	N/A	N/A	N/A
40310	Extension of Special Rule Relating to Qualified Timber Gains	N/A	N/A	N/A	N/A
40311	Extension of Empowerment Zone Tax Incentives	N/A	N/A	N/A	N/A
40312	Extension of American Samoa Economic Development Credit	N/A	N/A	N/A	N/A
40401	Extension of Credit for Nonbusiness Energy Property	N/A	N/A	N/A	N/A
40402	Modification and Extension of Credit for Residential Energy Property	N/A	N/A	N/A	N/A
40403	Extension of Credit for New Qualified Fuel Cell Motor Vehicles	N/A	N/A	N/A	N/A

**EXHIBIT C - REVENUE TABLES**

<b>Act Section</b>	<b>Provision</b>	<b>2018-19</b>	<b>2019-20</b>	<b>2020-21</b>	<b>2021-22</b>
40404	Extension of Credit for Alternative Fuel Vehicle Refueling Property	N/A	N/A	N/A	N/A
40405	Extension of Credit for 2-Wheeled Plug-In Electric Vehicles	N/A	N/A	N/A	N/A
40406	Extension of Second Generation Biofuel Producer Credit	N/A	N/A	N/A	N/A
40407	Extension of Biodiesel and Renewable Diesel Incentives	N/A	N/A	N/A	N/A
40408	Extension of Production Credit for Indian Coal Facilities	N/A	N/A	N/A	N/A
40409	Extension of Credits with Respect to Facilities Producing Energy from Certain Renewable Resources	N/A	N/A	N/A	N/A
40410	Extension of Credit for Energy-Efficient New Homes	N/A	N/A	N/A	N/A
40411	Extension and Phase-out of Energy Credit	N/A	N/A	N/A	N/A
40412	Extension of Special Allowance for Second Generation Biofuel Plant Property	N/A	N/A	N/A	N/A
40413	Extension of Energy Efficient Commercial Buildings Deduction	N/A	N/A	N/A	N/A
40414	Extension of Special Rule for Sales or Dispositions to Implement FERC or State Electric Restructuring Policy for Qualified Electric Utilities	N/A	N/A	N/A	N/A
40415	Extension of Excise Tax Credits Relating to Alternative Fuels	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.
40416	Increase and Extension of Oil Spill Liability Trust Fund	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.
40501	Modifications of Credit for Production from Advanced Nuclear Power Facilities	N/A	N/A	N/A	N/A
41102	Modifications to Rum Cover Over	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.

**EXHIBIT C - REVENUE TABLES**

<b>Act Section</b>	<b>Provision</b>	<b>2018-19</b>	<b>2019-20</b>	<b>2020-21</b>	<b>2021-22</b>
41103	Extension of Waiver of Limitations with Respect to Excluding from Gross Income Amounts Received by Wrongfully Incarcerated Individuals	N/A	N/A	N/A	N/A
41104	Individuals Held Harmless on Improper Levy on Retirement Plans	N/A	N/A	N/A	N/A
41105	Modification of User Fee Requirements for Installment Agreements	N/A	N/A	N/A	N/A
41106	Form 1040SR for Seniors	N/A	N/A	N/A	N/A
41107	Attorneys Fees Relating to Awards to Whistleblowers	N/A	N/A	N/A	N/A
41108	Clarification of Whistleblowers Awards	N/A	N/A	N/A	N/A
41109	Clarification Regarding 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.
41110	Exception from Private Foundation Excess Business Holding Tax for Independently-Operated Philanthropic Business Holdings	N/A	N/A	N/A	N/A
41111	Rule of Construction for Craft Beverage Modernization and Tax Reform	N/A	N/A	N/A	N/A
41112	Simplification of Rules Regarding Records, Statements, and Returns	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.
41113	Modification of Rules Governing Hardship Distributions	Baseline	Baseline	Baseline	Baseline
41114	Modification of Rules Relating to Hardship Withdrawals from Cash or Deferred Arrangements	Baseline	Baseline	Baseline	Baseline
41115	Opportunity Zone Rule for Puerto Rico	N/A	N/A	N/A	N/A
41116	Tax Home of Certain Citizens or Residents of the United States Living Abroad	N/A	N/A	N/A	N/A
41117	Treatment of Foreign Persons for Returns Relating to Payments Made in Settlement of Payment Card and Third Party Network Transactions	N/A	N/A	N/A	N/A

**EXHIBIT C - REVENUE TABLES**

Act Section	Provision	2018-19	2019-20	2020-21	2021-22
41118	Repeal of Shift in Time of Payment of Corporate Estimated Taxes	N/A	N/A	N/A	N/A
41119	Enhancement of Carbon Dioxide Sequestration Credit	N/A	N/A	N/A	N/A

**Table 3 – Consolidated Appropriations Act, 2018**  
(Public Law 115-141)

Act Section	Provision	2018-19	2019-20	2020-21	2021-22
Div. T - 101	Modification of Deduction for Qualified Business Income of a Cooperative and Its Patrons	N/A	N/A	N/A	N/A
Div. T - 102	Low-Income Housing Credit Ceiling	N/A	N/A	N/A	N/A
Div. T - 103	Low-Income Housing Credit Average Income Test	N/A	- \$250,000	- \$300,000	- \$400,000
Div. U – 101a	Earned Income Tax Credit Permanent Rules (PATH Act section 103)	N/A	N/A	N/A	N/A
Div. U - 101b	Transit Parity (PATH Act section 105)	Baseline	Baseline	Baseline	Baseline
Div. U – 101c	Research Credit: Not Reinstate Alternative Incremental Credit (PATH Act section 121) – Research Credit	N/A	N/A	N/A	N/A
Div. U – 101c	Research Credit: Not Reinstate Alternative Incremental Credit (PATH Act section 121) – Specified Credits Allowed Against Alternative Minimum Tax	N/A	N/A	N/A	N/A
Div. U – 101c	Research Credit: Not Reinstate Alternative Incremental Credit (PATH Act section 121) – Payroll Tax Credit	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.
Div. U - 101d	Bonus Depreciation (PATH Act section 143)	N/A	N/A	N/A	N/A
Div. U - 101e	Election Out of Accelerated Recovery Periods for Qualified Indian Reservation Property (PATH Act Section 167)	N/A	N/A	N/A	N/A
Div. U - 101f	Failure to Furnish Correct Payee Statements (PATH Act section 202)	N/A	N/A	N/A	N/A

**EXHIBIT C - REVENUE TABLES**

<b>Act Section</b>	<b>Provision</b>	<b>2018-19</b>	<b>2019-20</b>	<b>2020-21</b>	<b>2021-22</b>
Div. U - 101g	Requirements for the Issuance of Individual Taxpayer Identification Numbers (ITINs) (PATH Act section 203)	N/A	N/A	N/A	N/A
Div. U - 101h, I, j	Retroactive Claims of Credits (PATH Act sections 204, 205, and 206)	Baseline	Baseline	Baseline	Baseline
Div. U - 101k	Effective Date for Treatment of Credits for Certain Penalties (PATH Act section 209)	N/A	N/A	N/A	N/A
Div. U - 101l	Making American Opportunity Tax Credit Permanent (PATH Act sections 102, 206, 207, 208, and 211)	N/A	N/A	N/A	N/A
Div. U - 101m	Restriction on Tax-Free Distributions Involving Real Estate Investment Trusts (REITs) (PATH Act section 311)	N/A	N/A	N/A	N/A
Div. U - 101n	Ancillary Personal Property of a REIT (PATH Act section 318)	Baseline	Baseline	Baseline	Baseline
Div. U - 101o	Section 529 Programs and Qualified ABLE Programs (PATH Act section 302(b))	N/A	- \$4,000	- \$2,000	- \$3,000
Div. U - 101p	Exception from Foreign Investment in U.S. Real Property Tax Act for Certain Stock of REITs (PATH Act section 322)	N/A	N/A	N/A	N/A
Div. U - 101q	FIRPTA Exception for Qualified Foreign Pension Funds (PATH Act section 323)	N/A	N/A	N/A	N/A
Div. U - 101r	Election of Certain Small Insurance Companies to Be Taxed Only on Taxable Investment Income (PATH Act section 333)	N/A	N/A	N/A	N/A
Div. U - 102	Amendment Relating to Consolidated Appropriations Act, 2016	N/A	N/A	N/A	N/A
Div. U - 103	Amendments Relating to Fixing America's Surface Transportation Act	N/A	N/A	N/A	N/A
Div. U - 104a	Amendments Relating to the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 - Consistent Value for Transfer and Income Tax Purposes (Act section 2004)	Baseline	Baseline	Baseline	Baseline



**EXHIBIT C - REVENUE TABLES**

<b>Act Section</b>	<b>Provision</b>	<b>2018-19</b>	<b>2019-20</b>	<b>2020-21</b>	<b>2021-22</b>
Div. U - 104b	Amendments Relating to the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 - Mass Transit Account (MTA) Financing (Act section 2008)	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.
Div. U - 105a	Amendments Relating to the Stephen Beck, Jr., ABLE Act of 2014 - Failure to File Tax Return or Pay Tax	N/A	N/A	N/A	N/A
Div. U - 105b	Amendments Relating to the Stephen Beck, Jr., ABLE Act of 2014 - Tax Return Preparer's Failure to Furnish Copies to Taxpayers	N/A	N/A	N/A	N/A
Div. U - 105c	Amendments Relating to the Stephen Beck, Jr., ABLE Act of 2014 - Failure to File Certain Information Returns, Registration Statements, Etc.	N/A	N/A	N/A	N/A
Div. U - 105d	Amendments Relating to the Stephen Beck, Jr., ABLE Act of 2014 - Failure to File Partnership Returns	N/A	N/A	N/A	N/A
Div. U - 105e	Amendments Relating to the Stephen Beck, Jr., ABLE Act of 2014 - Failure to File S Corporation Returns	N/A	N/A	N/A	N/A
Div. U - 105f	Amendments Relating to the Stephen Beck, Jr., ABLE Act of 2014 - Failure to File Correct Information Returns & Failure to File Correct Payee Statement	N/A	N/A	N/A	N/A
Div. U - 106	Amendment Relating to the American Taxpayer Relief Act of 2012	N/A	N/A	N/A	N/A
Div. U - 109	Amendments Relating to the American Jobs Creation Act of 2004 - Treatment of Certain Trusts as Shareholder of S Corporation (Act section 233)	Baseline	Baseline	Baseline	Baseline
Div. U - 109	Amendments Relating to the American Jobs Creation Act of 2004 - Rural Electric Cooperatives (Act section 319)	N/A	N/A	N/A	N/A
Div. U - 201	Scope of Adjustments Subject to Partnership Audit Rules	N/A	N/A	N/A	N/A
Div. U - 202	Determination of Imputed Underpayments - Netting of Adjustment Items	Baseline	Baseline	Baseline	Baseline
Div. U - 202	Determination of Imputed Underpayments - Federal Imputed Underpayment	N/A	N/A	N/A	N/A

**EXHIBIT C - REVENUE TABLES**

Act Section	Provision	2018-19	2019-20	2020-21	2021-22
Div. U - 203	Alternative Procedure to Filing Amended Returns for Purposes of Modifying Imputed Underpayment	N/A	N/A	N/A	N/A
Div. U - 204	Treatment of Passthrough Partners in Tiered Structures	Baseline	Baseline	Baseline	Baseline
Div. U - 205	Treatment of Failure of Partnership to Pay Imputed Underpayment	N/A	N/A	N/A	N/A
Div. U - 206	Other Technical Corrections Related to Partnership Audit Rules	N/A	N/A	N/A	N/A
Div. U - 301	Amendments Relating to the Bipartisan Budget Act of 2015	N/A	N/A	N/A	N/A
Div. U - 302	Amendments Relating to the Energy Policy Act of 2005	N/A	Negligible <sup>881</sup>	Negligible <sup>882</sup>	Negligible <sup>883</sup>
Div. U - 401	Clerical Corrections and Deadwood-Related Provisions	N/A	N/A	N/A	N/A

**Table 4 –Consolidated Appropriations Act, 2018**  
(Public Law 115-271)

Act Section	Provision	2018-19	2019-20	2020-21	2021-22
Title IV - 4003	Additional Religious Exemption from Health Coverage Responsibility Requirement	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.

**Table 5 –Veterans Benefits and Transition Act, 2018**  
(Public Law 115-407)

Act Section	Provision	2018-19	2019-20	2020-21	2021-22
302	Residence of Spouses of Servicemembers for Tax Purposes	Baseline	Baseline	Baseline	Baseline

<sup>881</sup> Negligible revenue gain.

<sup>882</sup> Negligible revenue gain.

<sup>883</sup> Negligible revenue gain.