



STATE OF CALIFORNIA  
**Franchise Tax Board**

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## Summary of Federal Income Tax Changes 2019 – Part II

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### Laws Affected

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

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

# Summary of Federal Income Tax Changes – 2019

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# Summary of Federal Income Tax Changes – 2019

## EXECUTIVE SUMMARY

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

During 2019, the Internal Revenue Code (IRC) or its application by California was changed by:

PUBLIC LAW	TITLE	DATE
116-91	FUTURE Act	December 19, 2019
116-92	National Defense Authorization Act for Fiscal Year 2020	December 20, 2019
116-94	Further Consolidations Appropriations Act, 2020	December 20, 2019

## Summary of Federal Income Tax Changes – 2019

This report explains new 2019 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 (P.L.s), the IRC, and the California Revenue and Taxation Code (R&TC) impacted by the federal changes.

This report contains the following exhibits:

- Exhibit A      *2019 Miscellaneous Federal Acts Impacting the Internal Revenue Code 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 if California were to conform to the federal changes.

FUTURE Act  
Public Law 116-91, December 19, 2019

Section      Section Title

3      Secure Disclosure of Tax-return Information to Carry Out the Higher Education Act of 1965

Background

Present law prohibits the disclosure of returns and return information, except to the extent specifically authorized by the IRC. An exception was provided for disclosure to the Department of Education (ED) (but not to contractors thereof) of a taxpayer's filing status, adjusted gross income (AGI), and identity information (i.e., name, mailing address, taxpayer identifying number) to establish an appropriate repayment amount for an applicable student loan. However, this exception does not apply to requests made after December 31, 2007.

The ED utilizes contractors for the income-contingent loan verification program. The specific disclosure exception for the program does not permit disclosure of return information to contractors. As a result, the ED obtains return information from the Internal Revenue Service (IRS) by taxpayer consent (under IRC section 6103(c)), rather than under the specific exception for the income-contingent loan verification program (IRC section 6103(l)(13)).

New Federal Law (IRC section 6103(l)(13))

This section directs the IRS, upon the written request of the ED, to disclose to any authorized person, tax return information to determine eligibility for, or repayment obligations under income-contingent or income-based repayment plans of student loans, discharges of loans based on total and permanent disability, and the amount of student financial aid under specified parts of the Higher Education Act of 1965.

The bill requires the Secretary of Education to annually submit a written report to the Secretary of the Treasury (Secretary) regarding redisclosures of return information and unauthorized use, access, or disclosures of such information. The bill also requires the Secretary (or designee) to annually submit a written report to Congress on disclosures under this section, including the information provided by the ED.

Effective Date

The provision is effective for disclosures made after December 19, 2019.

FUTURE Act  
Public Law 116-91, December 19, 2019

California Law (None)

California has no disclosure provision comparable to IRC section 6103(l)(13), relating to tax return information to be disclosed to the federal ED to carry out income contingent repayment of student loans.

Impact on California Revenue

Not applicable.

National Defense Authorization Act for Fiscal Year 2020  
Public Law 116-92, December 20, 2019

Section      Section Title

1122 Prohibition on Criminal History Inquiries Prior to Conditional Offer for Federal Employment

Background

Current federal law<sup>1</sup> provides an above-the-line deduction for attorneys' fees and costs paid by, or on behalf of, the taxpayer in connection with any action involving:

- A claim of unlawful discrimination,
- Certain claims against the Federal Government, or
- A private cause of action under the Medicare Secondary Payer statute.

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 a judgment or settlement (whether by suit or agreement and whether as lump sum or periodic payments) resulting from such claim."<sup>2</sup>

For purposes of this deduction, "unlawful discrimination" is defined to mean an act that is unlawful under certain provisions of the following laws:<sup>3</sup>

- (1) The Civil Rights Act of 1991,
- (2) The Congressional Accountability Act of 1995,
- (3) The National Labor Relations Act,
- (4) The Fair Labor Standards Act of 1938,
- (5) The Age Discrimination in Employment Act of 1967,
- (6) The Rehabilitation Act of 1973,
- (7) The Employee Retirement Income Security Act of 1974,
- (8) Title IX of the Education Amendments of 1972,
- (9) The Employee Polygraph Protection Act of 1988,
- (10) The Worker Adjustment and Retraining Notification Act,
- (11) The Family and Medical Leave Act of 1993,

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<sup>1</sup> IRC section 62(a)(20).

<sup>2</sup> IRC section 62(a)(20).

<sup>3</sup> IRC section 62(e)(1)-(18).

National Defense Authorization Act for Fiscal Year 2020  
Public Law 116-92, December 20, 2019

- (12) Chapter 43 of Title 38 of the United States Code (U.S.C.),
- (13) The Revised Statutes,
- (14) The Civil Rights Act of 1964,
- (15) The Fair Housing Act,
- (16) The Americans with Disabilities Act of 1990,
- (17) Any provision of federal law (popularly known as whistleblower protection provisions) prohibiting the discharge of an employee, discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted under federal law, or
- (18) Any provision of federal, state or local law, or common law claims permitted under federal, state, or local law providing for the enforcement of civil rights; or regulating any aspect of the employment relationship, including claims for wages, compensation, or benefits, or prohibiting the discharge of an employee, discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.

New Federal Law (IRC section 62(e)(2))

The provision prohibits the required disclosure of certain criminal history record information by specified applicants for appointment to a position in civil service, prior to a conditional offer of employment.<sup>4</sup> The provision also amends IRC section 62(e)(2) to add the above prohibition to the list of laws included in the definition of “unlawful discrimination.”

Effective Date

The provision that amends the IRC is effective two years after December 20, 2021.

California Law (R&TC section 17072)

Under the Personal Income Tax Law (PITL), California generally conforms to the federal definition of AGI under IRC section 62 as of the specified date of January 1, 2015,<sup>5</sup> and as a result, does not conform to the federal amendment to the list of laws included in the definition of “unlawful discrimination.”

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<sup>4</sup> A conditional offer is considered to be an offer of employment that is conditioned upon the results of a criminal history inquiry.

<sup>5</sup> R&TC section 17072 conforms to IRC section 62, relating to the definition of AGI, as of the specified date of January 1, 2015, with modifications in subdivisions (b) and (c).



National Defense Authorization Act for Fiscal Year 2020  
Public Law 116-92, December 20, 2019

Impact on California Revenue

Estimated Conformity Revenue Impact of Prohibition on Criminal History Inquiries Prior to Conditional Offer for Federal Employment

For Taxable Years Beginning On or After January 1, 2020  
Enactment Assumed After June 30, 2020

2019-2020	2020-2021	2021-2022	2022-2023
N/A	Negligible	Negligible	Negligible

Further Consolidations Appropriations Act, 2020  
Public Law 116-94, December 20, 2019  
Division J — Foreign Policy  
Title IX — Other Matters

<u>Section</u>	<u>Section Title</u>
901	Special Rules for Certain Monthly Workers' Compensation Payments and Other Payments for Department of State Personnel under Chief of Mission Authority

Background

The United States (U.S.) government is required to pay monthly disability compensation to employees that sustain certain injuries that result in partial or total disability, while performing their job duties.<sup>6</sup>

Under the IRC, gross income does not include amounts received by an individual as disability income attributable to injuries incurred as a direct result of a terroristic or military action (as determined by the Secretary of State).<sup>7</sup>

The term "terroristic or military action"<sup>8</sup> means:

1. Any terroristic activity which a preponderance of the evidence indicates was directed against the U.S. or any of its allies, and
2. Any military action involving the Armed Forces of the U.S. and resulting from violence or aggression (or threat thereof) against the U.S. or any of its allies.

The term "military action" does not include training exercises.

New Federal Law (Uncodified Law Applicable to IRC section 104(a))

The provision authorizes the U.S. State Department to make additional monthly compensation payments for certain qualifying injuries sustained by U.S. State Department employees (covered employees) while serving in duty stations located in certain foreign countries. In addition, the U.S. State Department may reimburse the costs of covered employees, covered individuals, and covered dependents for diagnosis and treatment costs relating to certain qualifying injuries.

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<sup>6</sup> Chapter 81 of Subpart G of Part III of the Government Organization and Employees Code (Title 5).

<sup>7</sup> IRC section 104(b)(5).

<sup>8</sup> IRC section 692(c)(2).

Further Consolidations Appropriations Act, 2020  
Public Law 116-94, December 20, 2019

Under this provision, the following definitions apply:

- “Covered employee” means a U.S. State department employee who becomes injured by reason of a qualifying injury on or after January 1, 2016, and was assigned to a duty station in the Republic of Cuba, the People’s Republic of China, or another foreign country as designated by the Secretary of State.
- “Covered dependent” means a family member of an employee who becomes injured by reason of a qualifying injury on or after January 1, 2016, and accompanies the employee to an assigned duty station in a foreign country.
- “Covered individual” means a person who becomes injured by reason of a qualifying injury on or after January 1, 2016, while detailed to a duty station in the Republic of Cuba, the People’s Republic of China, or another foreign country as designated by the Secretary of State or affiliated with the Department of State.
- “Qualifying injury” is defined as:
  - With respect to a covered employee or a covered individual, an injury sustained during the period in which such person was assigned to a duty station (in locations defined above), in connection with war, insurgency, hostile act, terrorist activity, or other incident (as designated by the U.S. State Department), and that was not the result of willful neglect.
  - With respect to a covered dependent, a qualifying injury as defined for a covered employee or a covered individual, that was sustained while accompanying a covered employee that was not the result of the willful misconduct of the covered dependent.

These additional payments are excludable from gross income as disability income attributable to injuries incurred as a direct result of a terroristic or military action under IRC section 104(a)(5).

Effective Date

The provision is effective for payments made to covered employees on or after January 1, 2016, and for payments made for the costs of or to reimburse for diagnosis or treatment incurred on or after January 1, 2016.

California Law (R&TC section 17131)

California generally conforms to the federal income exclusion of compensation received for injuries or sickness under IRC section 104, as of the “specified date” of

Further Consolidations Appropriations Act, 2020  
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January 1, 2015.<sup>9,10</sup> California also conforms to uncodified federal provisions that relate to IRC sections to which it conforms, for the same taxable years.<sup>11</sup>

Because this provision was enacted after the “specified date”, California does not conform to the federal provision relating to special rules for certain monthly workers’ compensation payments and other payments for U.S. State Department personnel under Chief of Mission authority, as disability income attributable to injuries incurred as a direct result of a terroristic or military action.

Impact on California Revenue

Estimated Conformity Revenue Impact of Special Rules for Certain Monthly Workers’ Compensation Payments and Other Payments for Department of State Personnel under Chief of Mission Authority

For Taxable Years Beginning On or After January 1, 2020  
Enactment Assumed After June 30, 2020

2019-2020	2020-2021	2021-2022	2022-2023
N/A	Negligible	Negligible	Negligible

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Division M — Bipartisan American Miners

Section      Section Title

104            Reduction in Minimum Age for Allowable In-service Distributions

Background

The House Ways and Means Committee report states:

Tax-favored employer-sponsored retirement plans consist of qualified retirement plans, including certain defined contribution plans that allow employees to make elective deferrals (a “section 401(k) plan”), tax-deferred annuity plans (a “section 403(b) plan”), which may also allow employees to make elective deferrals, and eligible deferred compensation plans of State and local government employers (a

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<sup>9</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>10</sup> R&TC section 17024.5.

<sup>11</sup> R&TC section 17024.5(a)(2)(A).

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“governmental section 457(b) plan”).<sup>12</sup> The terms of an employer-sponsored retirement plan generally determine when distributions are permitted. However, in some cases, restrictions may apply to distribution before an employee’s severance from employment, referred to as “in-service” distributions.

In-service distributions of elective deferrals (and related earnings) under a section 401(k) plan generally are permitted only after attainment of age 59½ or termination of the plan.<sup>13</sup> In-service distributions of elective deferrals (but not related earnings) are also permitted in the case of hardship. Elective deferrals under a section 403(b) plan are subject to in-service distribution restrictions similar to those applicable to elective deferrals under a section 401(k) plan, and, in some cases, other contributions to a section 403(b) plan are subject to similar restrictions.<sup>14</sup>

Pension plans, that is, qualified defined benefit plans and money purchase pension plans, a type of qualified defined contribution plan, generally may not permit in-service distributions before attainment of age 62 (or attainment of normal retirement age under the plan if earlier) or termination of the plan.<sup>15</sup>

Deferrals under a governmental section 457(b) plan are subject to in-service distribution restrictions similar to those applicable to elective deferrals under a section 401(k) plan, except that in-service distributions under a governmental section 457(b) plan are permitted only after attainment of age 70½ (rather than age 59½).<sup>16,17</sup>

New Federal Law (IRC sections 401(a)(36), and 457(d)(1)(A))

The provision would reduce the age of permitted in-service distributions from 62 years to 59½ years for pension plans as described in IRC section 401(a)(36) and from 70½ years to 59½ years for a governmental deferred compensation 457(b) plan. This provision makes the rules for those plans consistent with the rules for the plans described by IRC sections 401(k) and 403(b).<sup>18</sup>

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<sup>12</sup> IRC sections 401(a), 401(k), 403(a), 403(b), and 457(b).

<sup>13</sup> IRC section 401(k)(2)(B). Similar restrictions apply to certain other contributions, such as employer matching or non-elective contributions required under the nondiscrimination safe harbors under section 401(k).

<sup>14</sup> IRC sections 403(b)(7)(A)(ii) and 403(b)(11).

<sup>15</sup> IRC section 401(a)(36) and Treasury Regulations (Treas. Reg.) sections 1.401-1(b)(1)(i) and 1.401(a)-1(b).

<sup>16</sup> IRC section 457(d)(1)(A).

<sup>17</sup> House of Representatives Report (H.R. Rpt.) No. 115-409-1, 1<sup>st</sup> Sess., pp. 194-195 (2017).

<sup>18</sup> See Explanation of Provision, H.R. Rpt. No. 115-409-1, 1<sup>st</sup> Sess., p. 195 (2017).

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Public Law 116-94, December 20, 2019

Effective Date

The provision applies to plan years beginning after December 31, 2019.

California Law (R&TC sections 17501, 17551, and 24601)

California conforms, under the PITL and the Corporation Tax Law (CTL), by reference to Subchapter D of Chapter 1 of Subtitle A of the IRC, relating to pensions, deferred compensation, etc., consisting of Part I, relating to pension, profit-sharing, stock bonus plans, etc., (IRC sections 401 through 420) and Part II, relating to certain stock options (IRC sections 421 through 424), under R&TC sections 17501 and 24601. In addition, California conforms, under the PITL, by reference to Subchapter E of Chapter 1 of Subtitle A of the IRC, relating to accounting periods and methods of accounting, consisting of IRC sections 441 through 483, inclusive, in R&TC section 17551(a) as of the “specified date” of January 1, 2015.<sup>19</sup>

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. In addition, R&TC section 17551(c)(1) provides that with respect to IRC section 457, these provisions shall apply without regard to taxable year to the same extent as applicable for federal income tax purposes and thus adopt all changes made to those IRC sections without regard to the “specified date” contained in R&TC section 17024.5.

Therefore, the federal changes to IRC sections 401 and 457 made by this provision are applicable for California purposes without regard to taxable year to the same extent as applicable for federal income tax purposes.

Impact on California Revenue

Baseline.

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Division N – Health and Human Services Extenders  
Subtitle A — Medical Provisions

Section      Section Title

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<sup>19</sup> R&TC section 17024.5.

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Public Law 116-94, December 20, 2019

104            Extension of Appropriations to the Patient-Centered Outcomes Research Trust Fund; Extension of Certain Health Insurance Fees

Background

Under IRC section 9511, a trust fund was established in the Treasury of the U.S., the Patient Centered Outcomes Research Trust Fund (“PCORTF”), to carry out comparative effectiveness research. The PCORTF is funded in part from fees imposed on health plans under IRC sections 4375 through 4377, related to health insurance and self-insured health plans.

The fee assessed on health insurance plans under IRC section 4375 is imposed on each specified health insurance policy multiplied by the average number of lives covered under the policy. The issuer of the policy is liable for payment of the fee. A specified health insurance policy includes any accident or health insurance policy<sup>20</sup> issued with respect to individuals residing in the U.S.<sup>21</sup>

In the case of applicable self-insured health plans, IRC section 4376 imposes a fee based on each policy multiplied by the average number of lives covered under the plan. The plan sponsor is liable for payment of the fee. For purposes of the provision, the plan sponsor is: (1) the employer in the case of a plan established or maintained by a single employer; or (2) the employee organization in the case of a plan established or maintained by an employee organization. In the case of a plan established or maintained by two or more employers or jointly by one or more employers and one or more employee organizations, a multiple employer welfare arrangement, or a voluntary employees’ beneficiary association described in IRC section 501(c)(9) (VEBA), the plan sponsor is the association, committee, joint board of trustees, or other similar group of representatives of the parties who establish or maintain the plan.

Under the provision, an applicable self-insured health plan is any plan providing accident or health coverage if any portion of such coverage is provided other than through an insurance policy and such plan is established or maintained:  
(1) by one or more employers for the benefit of their employees or former employees;  
(2) by one or more employee organizations for the benefit of their members or former

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<sup>20</sup> A specified health insurance policy does not include insurance if substantially all of the coverage provided under such policy consists of excepted benefits described in IRC section 9832(c). Examples of excepted benefits described in IRC section 9832(c) are coverage for only accident, or disability insurance, or any combination thereof; liability insurance, including general liability insurance and automobile liability insurance; workers’ compensation or similar insurance; automobile medical payment insurance; coverage for on-site medical clinics; limited scope dental or vision benefits; benefits for long term care, nursing home care, community based care, or any combination thereof; coverage only for a specified disease or illness; hospital indemnity or other fixed indemnity insurance; and Medicare supplemental coverage.

<sup>21</sup> Under the provision, the U.S. includes any possession of the U.S.

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members; (3) jointly by one or more employers and one or more employee organizations for the benefit of employees or former employees; (4) by a VEBA; (5) by any organization described in IRC section 501(c)(6); or (6) in the case of a plan not previously described, by a multiple employer welfare arrangement (as defined in section 3(40) of Employee Retirement Income Security Act of 1974 (ERISA), a rural electric cooperative (as defined in section 3(40)(B)(iv) of ERISA), or a rural telephone cooperative association (as defined in section 3(40)(B)(v) of ERISA).

Governmental entities are generally not exempt from the fees imposed under the provision. There is an exception for “exempt governmental programs” including, Medicare, Medicaid, State Children’s Health Insurance Program (SCHIP), and any program established by federal law for providing medical care (other than through insurance policies) to members (or the spouses and dependents thereof) of the Armed Forces, veterans, or members of Indian tribes. No amount collected from the fee on health insurance and self-insured plans is covered over to any possession of the U.S. For purposes of the IRC’s procedure and administration rules, the fee imposed under the IRC sections 4375 through 4376 is treated as a tax, and did not apply to plan years ending after September 31, 2019.

New Federal Law (IRC sections 4375, 4376, and 9511)

The provision extends imposition of the fees imposed under IRC section 4375 and section 4376 to policy or plan years ending after September 30, 2029. In addition, the provision extends the appropriations to the PCORTF for fiscal year 2020 through fiscal year 2029, and provides an annual appropriation amount for each fiscal year that would be received from the fees imposed under IRC sections 4375 and 4376.

Effective Date

With respect to policy or plan years, the fee on health insurance policies and self-insured plans remains in effect until years ending after September 30, 2029. No amounts shall be available for expenditure from the PCORTF after September 30, 2029, and any amounts after that date will be transferred to the general fund.



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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 E — Revenue Provisions

Section      Section Title

501              Repeal of 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>22</sup> A taxable medical device is any device, as defined in section 201(h) of the Federal Food, Drug, and Cosmetic Act,<sup>23</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>24</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.

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<sup>22</sup> IRC section 4191.

<sup>23</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>24</sup> Treas. Reg. 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.

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The Protecting Americans from Tax Hikes Act of 2015<sup>25</sup> (PATH Act) suspended the medical device tax for two years, for sales during the period beginning on January 1, 2016, and ending on December 31, 2017, and the Federal Register Printing Savings Act of 2017<sup>26</sup> suspended the medical device excise tax for two additional years, for sales after December 31, 2017, and through December 31, 2019.

New Federal Law (IRC sections 4221 and 6416(b))

The provision repeals the medical device excise tax.

Effective Date

The provision applies to sales after December 31, 2019.

California Law (None)

The FTB does not administer these types of excise tax.

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>
502	Repeal of Annual Fee on Health Insurance Providers

Background

An annual fee applies to any covered entity engaged in the business of providing health insurance with respect to U.S. health risks. The fee applies for calendar years beginning after 2013. The aggregate annual fee for all covered entities is the applicable amount of, \$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.

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

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<sup>25</sup> P.L. 114-113, Division Q, section 174(a), enacted December 18, 2015.

<sup>26</sup> P.L. 115-120, Division D, section 4001, enacted January 22, 2018.

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the applicable amount as the covered entity's net premiums written during the preceding calendar year with respect to health insurance for any U.S. health risk, bears to the aggregate net written premiums of all covered entities during such preceding calendar year with respect to such health insurance.

The Secretary is required 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 U.S. 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.

"Net written premiums" means 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>27</sup>

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>28</sup> of a health insurance organization that is exempt from federal income tax<sup>29</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 U.S. 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 U.S. health risks, or an insurer that provides health insurance with respect to U.S. health risks under Medicare Advantage, Medicare Part D, or Medicaid, is a covered entity under the provision except as provided in specific exceptions.

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<sup>27</sup> See *Helvering v. Le Gierse*, 312 U.S. 531 (1941).

<sup>28</sup> The exempt activities for this purpose are activities other than activities of an unrelated trade or business defined in IRC section 513.

<sup>29</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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Health insurance does not include coverage for accident, or disability income insurance, or a combination thereof; for a specified disease or illness; hospital indemnity or other fixed-indemnity insurance; or any insurance for long-term care or any Medicare supplemental health insurance (as defined in section 1882(g)(1) of the Social Security Act (SSA)).

New Federal Law (Uncodified Section 9010 of Subtitle A of Title IX of the Patient Protection and Affordable Care Act)

The provision repeals the annual fee on health insurance providers.

Effective Date

The provision applies to calendar years beginning after December 31, 2020.

California Law (R&TC sections 13201–13222 and Section 28 of Article XIII of the California Constitution)

*Insurance Companies in General*

Insurance companies must be admitted to do business in California. Once admitted, those insurance companies pay the gross premiums tax that is jointly administered by the State Board of Equalization (SBE), the CDTFA, the California Department of Insurance, and the California State Controller. 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>30</sup>

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

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<sup>30</sup> R&TC sections 13201–13222.

Impact on California Revenue

*Insurance Companies in General*

The FTB does not administer these types of excise taxes.

*Nonadmitted Insurance Policyholders*

Not applicable.

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<u>Section</u>	<u>Section Title</u>
503	Repeal of Excise Tax on High Cost Employer-sponsored Health Coverage

Background

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. In 2020 and thereafter, the threshold amounts are indexed to the CPI-U as determined by the Department of Labor (DOL), 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 Federal Employees Health Benefits Program (FEHBP) coverage for the type of coverage provided to the individual if priced for the age and gender characteristics of all employees of the individual's employer, over the premium cost, determined under procedures prescribed by the Secretary, for that coverage if priced for the age and gender characteristics of the national workforce.

The excise tax is imposed pro rata on the issuers of the insurance.

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.

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### Deductibility of Excise Tax

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

### Delay in Implementation

The Federal Register Printing Savings Act of 2017<sup>31</sup> delayed the excise tax on high-cost employer-sponsored health coverage for two years, delaying application to taxable years beginning after December 31, 2021.

### New Federal Law (IRC section 4980I)

The provision repeals the excise tax on high cost employer-sponsored health coverage.

### Effective Date

The provision applies to taxable years beginning after December 31, 2019.

### 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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Division O — Setting Every Community up for Retirement Enhancement  
Title I — Expanding and Preserving Retirement Savings

<u>Section</u>	<u>Section Title</u>
101	Multiple Employer Plans; Pooled Employer Plans

### Background

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>32</sup>

Retirement Savings under the IRC and ERISA

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<sup>31</sup> P.L. 115-120, Division D, Section 4001, enacted January 22, 2018.

<sup>32</sup> Joint Committee on Taxation, Description of the Chairman’s Amendment in the Nature of a Substitute to H.R. 1994, the “Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019,” JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, pp. 2-8.

### *Tax-Favored Arrangements*

The IRC provides two general vehicles for tax-favored retirement savings: employer-sponsored plans and individual retirement arrangements (IRAs). IRC provisions are generally within the jurisdiction of the [Secretary], through his or her delegate, the [IRS].

The most common type of tax-favored employer-sponsored retirement plan is a qualified retirement plan,<sup>33</sup> which may be a defined contribution plan or a defined benefit plan. Under a defined contribution plan, separate individual accounts are maintained for participants, to which accumulated contributions, earnings, and losses are allocated, and participants' benefits are based on the value of their accounts.<sup>34</sup> Defined contribution plans commonly allow participants to direct the investment of their accounts, usually by choosing among investment options offered under the plan. Under a defined benefit plan, benefits are determined under a plan formula and paid from general plan assets, rather than individual accounts.<sup>35</sup> Besides qualified retirement plans, certain tax-exempt employers and public schools may maintain tax-deferred annuity plans.<sup>36</sup>

An IRA is generally established by the individual for whom the IRA is maintained.<sup>37</sup> However, in some cases, an employer may establish IRAs on behalf of employees and provide retirement contributions to the IRAs.<sup>38</sup> In addition, IRA treatment may apply to accounts maintained for employees under a trust created by an employer (or an employee association) for the

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<sup>33</sup> IRC section 401(a). A qualified annuity plan under IRC section 403(a) is similar to and subject to requirements similar to those applicable to qualified retirement plans. Unless otherwise stated, all section references are to the IRC of 1986, as amended.

<sup>34</sup> IRC section 414(i). Defined contribution plans generally provide for contributions by employers and may include a qualified cash or deferred arrangement under an IRC section 401(k) plan, under which employees may elect to contribute to the plan.

<sup>35</sup> IRC section 414(j).

<sup>36</sup> IRC section 403(b). Private and governmental employers that are exempt from tax under IRC section 501(c)(3), including tax-exempt private schools, may maintain tax-deferred annuity plans. State and local governmental employers may maintain another type of tax-favored retirement plan, an eligible deferred compensation plan under IRC section 457(b).

<sup>37</sup> IRC sections 219, 408 and 408A provide rules for IRAs. Under IRC sections 408(a)(2) and (n), only certain entities are permitted to be the trustee of an IRA. The trustee of an IRA generally must be a bank, an insured credit union, or a corporation subject to supervision and examination by the Commissioner of Banking or other officer in charge of the administration of the banking laws of the State in which it is incorporated. Alternatively, an IRA trustee may be another person who demonstrates to the satisfaction of the Secretary that the manner in which the person will administer the IRA will be consistent with the IRA requirements.

<sup>38</sup> Simplified employee pension (SEP) plans under IRC section 408(k) and [Savings Incentive Match Plan for Employees] (SIMPLE) IRA plans under IRC section 408(p) are employer-sponsored retirement plans funded using IRAs for employees.



exclusive benefit of employees or their beneficiaries, provided that the trust complies with the relevant IRA requirements and separate accounting is maintained for the interest of each employee or beneficiary (referred to herein as an IRA trust).<sup>39</sup> In that case, the assets of the trust may be held in a common fund for the account of all individuals who have an interest in the trust.

## ERISA

Retirement plans of private employers, including qualified retirement plans and tax-deferred annuity plans, are generally subject to requirements under the [ERISA].<sup>40</sup> A plan covering only business owners (or business owners and their spouses) - that is, it covers no other employees - is exempt from ERISA.<sup>41</sup> Thus, a plan covering only self-employed individuals is exempt from ERISA. Tax-deferred annuity plans that provide solely for salary reduction contributions by employees may be exempt from ERISA.<sup>42</sup> IRAs are generally exempt from ERISA.

The provisions of Title I of ERISA are under the jurisdiction of the Secretary of Labor.<sup>43</sup> Many of the requirements under Title I of ERISA parallel IRC requirements for qualified retirement plans. Under ERISA, in carrying out provisions relating to the same subject matter, the [Secretary] and the Secretary of Labor are required to consult with each other and develop rules, regulations, practices, and forms that, to the extent appropriate for efficient administration, are designed to reduce duplication of effort, duplication of reporting, conflicting or overlapping requirements, and the burden of compliance by plan administrators, employers, and participants and beneficiaries.<sup>44</sup> In addition, interpretive jurisdiction over parallel IRC and ERISA provisions relating to retirement plans is divided between the two Secretaries by Executive Order, referred to as the Reorganization Plan No. 4 of 1978.<sup>45</sup>

## Multiple Employer Plans under the IRC

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<sup>39</sup> IRC section 408(c).

<sup>40</sup> ERISA applies to employee welfare benefit plans, such as health plans, of private employers, as well as to employer-sponsored retirement (or pension) plans. Employer-sponsored welfare and pension plans are both referred to under ERISA as employee benefit plans. Under ERISA sections 4(b)(1) and (2), governmental plans and church plans are generally exempt from ERISA.

<sup>41</sup> 29 [Code of Federal Regulations] C.F.R. 2510.3-3(b)-(c).

<sup>42</sup> 29 C.F.R. 2510.3-2(f).

<sup>43</sup> The provisions of Title I of ERISA are codified at 29 U.S.C. 1001-734. Under Title IV of ERISA, defined benefit plans of private employers are generally covered by the Pension Benefit Guaranty Corporation's pension insurance program.

<sup>44</sup> ERISA section 3004.

<sup>45</sup> 43 Federal Registry (Fed. Reg.) 47713 (October 17, 1978).



### *In General*

Qualified retirement plans, either defined contribution or defined benefit plans, are categorized as single-employer plans or multiple employer plans. A single-employer plan is a plan maintained by one employer. For this purpose, businesses and organizations that are members of a controlled group of corporations, a group under common control, or an affiliated service group are treated as one employer (referred to as aggregation).<sup>46</sup>

A multiple employer plan generally is a single plan maintained by two or more unrelated employers (that is, employers that are not treated as a single employer under the aggregation rules).<sup>47</sup> Multiple employer plans are commonly maintained by employers in the same industry and are used also by professional employer organizations (PEOs) to provide qualified retirement plan benefits to employees working for PEO clients.<sup>48</sup>

### *Application of IRC Requirements to Multiple Employer Plans and (Employee Plans Compliance Resolution System) EPCRS*

Some requirements are applied to a multiple employer plan on a plan-wide basis.<sup>49</sup> For example, all employees covered by the plan are treated as employees of all employers participating in the plan for purposes of the exclusive benefit rule. Similarly, an employee's service with all participating employers is taken into account in applying the minimum participation and vesting requirements. In applying the limits on contributions and benefits, compensation, contributions, and benefits attributable to all employers are taken into account.<sup>50</sup> Other requirements are applied separately, including the minimum coverage requirements, nondiscrimination requirements (both the general requirements and the special tests for IRC section 401(k) plans), and the top-heavy rules.<sup>51</sup> However, the qualified status of the plan as a whole is determined with respect to all employers maintaining the plan, and the failure by one employer (or by the plan itself) to satisfy an applicable

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<sup>46</sup> IRC sections 414(b), (c), (m) and (o).

<sup>47</sup> IRC section 413(c). Multiple employer status does not apply if the plan is a multiemployer plan. Multiemployer plans are different from single employer plans and multiple employer plans. A multiemployer plan is defined under IRC section 414(f) as a plan maintained pursuant to one or more collective bargaining agreements with two or more unrelated employers and to which the employers are required to contribute under the collective bargaining agreement(s). Multiemployer plans are also known as Taft-Hartley plans.

<sup>48</sup> Revenue Procedure (Rev. Proc.) 2003-86, 2003-2 Cumulative Bulletin (C.B.) 1211, and Rev. Proc. 2002-21, 2002-1 C.B. 911, address the application of the multiple employer plan rules to qualified defined contribution plans maintained by PEOs.

<sup>49</sup> IRC section 413(c).

<sup>50</sup> Treas. Reg. section 1.415(a)-1(e).

<sup>51</sup> Treas. Reg. sections 1.413-2(a)(3)(ii)-(iii) and 1.416-1, G-2.

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qualification requirement may result in disqualification of the plan with respect to all employers (sometimes referred to as the “one bad apple rule”).<sup>52</sup>

Because of the complexity of the requirements for qualified retirement plans, errors in plan documents, as well as plan operation and administration, commonly occur. Under a strict application of these requirements, such an error would cause a plan to lose its tax-favored status, which would fall most heavily on plan participants because of the resulting current income inclusion of vested amounts under the plan. As a practical matter, therefore, the IRS rarely disqualifies a plan. Instead, the IRS has established EPCRS, a formal program under which employers and other plan sponsors can correct compliance failures and continue to provide their employees with retirement benefits on a tax-favored basis.<sup>53</sup>

EPCRS has three components, providing for self-correction, voluntary correction with IRS approval, and correction on audit. The Self-Correction Program (SCP) generally permits a plan sponsor that has established compliance practices and procedures to correct certain insignificant failures at any time (including during an audit), and certain significant failures generally within a two-year period, without payment of any fee or sanction. The Voluntary Correction Program (VCP) permits an employer, at any time before an audit, to pay a limited fee and receive IRS approval of a correction. For a failure that is discovered on audit and corrected, the Audit Closing Agreement Program (Audit CAP) provides for a sanction that bears a reasonable relationship to the nature, extent, and severity of the failure and that takes into account the extent to which correction occurred before audit.

Multiple employer plans are eligible for EPCRS, and certain special procedures apply.<sup>54</sup> A VCP request with respect to a multiple employer plan must be submitted to the IRS by the plan administrator, rather than an employer maintaining the plan, and must be made with respect to the entire plan, rather than a portion of the plan affecting any particular employer. In addition, if a failure applies to fewer than all of the employers under the plan, the plan administrator may choose to have a VCP compliance fee or Audit CAP sanction calculated separately for each employer based on the participants attributable to that employer, rather than having the compliance fee calculated based on the participants of the entire plan. For example, the plan administrator may choose this option when the failure is attributable to the

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<sup>52</sup> Treas. Reg. sections 1.413-2(a)(3)(iv) and 1.416-1, G-2.

<sup>53</sup> Rev. Proc. 2016-51, 2016-42 I.R.B. 465.

<sup>54</sup> Section 10.11 of Rev. Proc. 2016-51.

failure of an employer to provide the plan administrator with full and complete information.

ERISA

### *Fiduciary and Bonding Requirements*

Among other requirements, ERISA requires a plan to be established and maintained pursuant to a written instrument (that is, a plan document) that contains certain terms.<sup>55</sup> The terms of the plan must provide for one or more named fiduciaries that jointly or severally have authority to control and manage the operation and administration of the plan.<sup>56</sup> Among other required plan terms are a procedure for the allocation of responsibilities for the operation and administration of the plan and a procedure for amending the plan and for identifying the persons who have authority to amend the plan. Among other permitted terms, a plan may provide also that any person or group of persons may serve in more than one fiduciary capacity with respect to the plan (including service both as trustee and administrator) and that a person who is a named fiduciary with respect to the control or management of plan assets may appoint an investment manager or managers to manage plan assets.

In general, a plan fiduciary is responsible for the investment of plan assets. However, ERISA section 404(c) provides a special rule in the case of a defined contribution plan that permits participants to direct the investment of their individual accounts.<sup>57</sup> Under the special rule, if various requirements are met, a participant is not deemed to be a fiduciary by reason of directing the investment of the participant's account and no person who is otherwise a fiduciary is liable for any loss, or by reason of any breach, that results from the participant's investments. Defined contribution plans that provide for participant-directed investments commonly offer a set of investment options among which participants may choose. The selection of investment options to be offered under a plan is subject to ERISA fiduciary requirements.

Under ERISA, any plan fiduciary or person that handles plan assets is required to be bonded, generally for an amount not to exceed \$500,000.<sup>58</sup> In some cases, the maximum bond amount is \$1 million, rather than \$500,000.

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<sup>55</sup> ERISA section 402.

<sup>56</sup> Fiduciary is defined in ERISA section 3(21), and named fiduciary is defined in ERISA section 402(a)(2).

<sup>57</sup> ERISA section 404(c). Under ERISA, a defined contribution plans is also referred to as an individual account plan.

<sup>58</sup> ERISA section 412.

### *Multiple Employer Plan Status under ERISA*

Like the IRC, ERISA contains rules for multiple employer retirement plans.<sup>59</sup> However, a different concept of multiple employer plan applies under ERISA.

Under ERISA, an employee benefit plan (whether a pension plan or a welfare plan) must be sponsored by an employer, by an employee organization, or by both.<sup>60</sup> The definition of employer is any person acting directly as an employer, or indirectly in the interest of an employer, in relation to an employee benefit plan, and includes a group or association of employers acting for an employer in such capacity.<sup>61</sup>

These definitional provisions of ERISA are interpreted as permitting a multiple employer plan to be established or maintained by a cognizable, bona fide group or association of employers, acting in the interests of its employer members to provide benefits to their employees.<sup>62</sup> This approach is based on the premise that the person or group that maintains the plan is tied to the employers and employees that participate in the plan by some common economic or representational interest or genuine organizational relationship unrelated to the provision of benefits. Based on the facts and circumstances, the employers that participate in the benefit program must, either directly or indirectly, exercise control over that program, both in form and in substance, in order to act as a bona fide employer group or association with respect to the program, or the plan is sponsored by one or more employers as defined in section 3(5) of ERISA.<sup>63</sup>

However, an employer association does not exist where several unrelated employers merely execute participation agreements or similar documents as a means to fund benefits, in the absence of any genuine organizational relationship between the employers. In that case, each participating employer establishes and maintains a separate employee benefit plan for the benefit of its own employees, rather than a multiple employer plan.

### *Form 5500 Reporting*

Under the IRC, an employer maintaining a qualified retirement plan generally is required to file an annual return containing information required under regulations with respect to the qualification, financial condition, and operation

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<sup>59</sup> ERISA section 210(a).

<sup>60</sup> ERISA sections 3(1) and (2).

<sup>61</sup> ERISA section 3(5).

<sup>62</sup> See, for example, DOL Advisory Opinions 2012-04A, 2003-17A, 2001-04A, and 1994-07A, and other authorities cited therein.

<sup>63</sup> See, for example, DOL Advisory Opinion 2017-02AC.

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of the plan.<sup>64</sup> ERISA requires the plan administrator of certain pension and welfare benefit plans to file annual reports disclosing certain information to the DOL.<sup>65</sup> These filing requirements are met by filing a completed Form 5500, Annual Return/Report of Employee Benefit Plan. Forms 5500 are filed with DOL, and information from Forms 5500 is shared with the IRS.<sup>66</sup> In the case of a multiple employer plan, the annual report must include a list of participating employers and a good faith estimate of the percentage of total contributions made by the participating employers during the plan year. Certain small plans, that is, plans covering fewer than 100 participants, are eligible for simplified reporting requirements, which are met by filing Form 5500-SF, Short Form Annual Return/Report of Small Employee Benefit Plan.<sup>67</sup>

New Federal Law (IRC sections 408 and 413)

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>68</sup>

In General

The proposal amends the IRC rules relating to multiple employer plans to provide relief from the “one bad apple” rule for certain plans (referred to herein as “covered multiple employer plans”). A covered multiple employer plan is a multiple employer qualified defined contribution plan<sup>69</sup> or a plan that consists of IRAs (referred to herein as an “IRA plan”), including under an IRA trust,<sup>70</sup> that either (1) is maintained by employers which have a common

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<sup>64</sup> IRC section 6058. In addition, under IRC section 6059, the plan administrator of a defined benefit plan subject to the minimum funding requirements is required to file an annual actuarial report. Under IRC section 414(g) and ERISA section 3(16), plan administrator generally means the person specifically so designated by the terms of the plan document. In the absence of a designation, the plan administrator generally is (1) in the case of a plan maintained by a single employer, the employer, (2) in the case of a plan maintained by an employee organization, the employee organization, or (3) in the case of a plan maintained by two or more employers or jointly by one or more employers and one or more employee organizations, the association, committee, joint board of trustees, or other similar group of representatives of the parties that maintain the plan. Under ERISA, the party described in (1), (2), or (3) is referred to as the “plan sponsor.”

<sup>65</sup> ERISA sections 103 and 104. Under ERISA section 4065, the plan administrator of certain defined benefit plans must provide information to the [Pension Benefit Guaranty Corporation] PBGC.

<sup>66</sup> Information is shared also with the PBGC, as applicable. Form 5500 filings are also publicly released in accordance with IRC section 6104(b) and Treas. Reg. section 301.6104(b)-1 and ERISA sections 104(a)(1) and 106(a).

<sup>67</sup> ERISA section 104(b).

<sup>68</sup> Joint Committee on Taxation, Description of the Chairman’s Amendment in the Nature of a Substitute to H.R. 1994, the “Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019,” JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, pp. 8-14.

<sup>69</sup> To which IRC section 413(c) applies.

<sup>70</sup> Under the proposal, in applying the exclusive benefit requirement under IRC section 408(c) to an IRA plan with an IRA trust covering employees of unrelated employers, all employees covered by the plan are treated as employees of all employers participating in the plan.

interest other than having adopted the plan, or (2) in the case of a plan not described in (1), has a pooled plan provider (referred to herein as a “pooled provider plan”), and which meets certain other requirements as described below.

The proposal outlines various requirements that apply to a pooled provider plan under the IRC. It also outlines various requirements that apply under ERISA to a qualified defined contribution plan that is established or maintained for the purpose of providing benefits to the employees of two or more employers and that meets certain requirements to be a “pooled employer plan,” and provides that a pooled employer plan is treated for purposes of ERISA as a single plan that is a multiple employer plan.<sup>71</sup>

## Tax-Favored Status under the IRC

### *In General*

The proposal provides relief from disqualification (or other loss of tax-favored status) of the entire plan merely because one or more participating employers fail to take actions required with respect to the plan (that is, relief from the “one bad apple” rule).

Such relief under the proposal does not apply to a plan unless the terms of the plan provide that, in the case of any employer in the plan failing to take required actions (referred to herein as a “noncompliant employer”) —

- Plan assets attributable to employees of the noncompliant employer (or beneficiaries of such employees) will be transferred to a plan maintained only by that employer (or its successor), to a tax-favored retirement plan for each individual whose account is transferred,<sup>72</sup> or to any other arrangement that the Secretary determines is appropriate, unless the Secretary determines it is in the best interests of the employees of the noncompliant employer (and beneficiaries of such employees) to retain the assets in the plan, and
- The noncompliant employer (and not the plan with respect to which the failure occurred or any other employer in the plan) is, except to the

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<sup>71</sup> With respect to plans described under proposed IRC section 413(e)(1)(A), other than providing relief from the “one bad apple” rule if certain requirements are met and adding certain reporting requirements, the proposal generally does not change present law and related guidance applicable to such multiple employer plans under the IRC or ERISA.

<sup>72</sup> For this purpose, a tax-favored retirement plan means an eligible retirement plan as defined in IRC section 402(c)(8)(B), that is, an IRA, a qualified retirement plan, a tax-deferred annuity plan under IRC section 403(b), or an eligible deferred compensation plan of a State or local governmental employer under IRC section 457(b).



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extent provided by the Secretary, liable for any plan liabilities attributable to employees of the noncompliant employer (or beneficiaries of such employees).

In addition, in the case of a pooled provider plan, if the pooled plan provider does not perform substantially all the administrative duties required of the provider (as described below) for any plan year, the Secretary may provide that the determination as to whether the plan meets the IRC requirements for tax-favored treatment will be made in the same manner as would be made without regard to the relief under the proposal.

*Pooled Plan Provider*

Under the proposal, “pooled plan provider” with respect to a plan means a person that:

- Is designated by the terms of the plan as a named fiduciary under ERISA,<sup>73</sup> as the plan administrator, and as the person responsible to perform all administrative duties (including conducting proper testing with respect to the plan and the employees of each employer in the plan) that are reasonably necessary to ensure that the plan meets the IRC requirements for tax-favored treatment and the requirements of ERISA and to ensure that each employer in the plan takes actions as the Secretary or the pooled plan provider determines necessary for the plan to meet IRC and ERISA requirements, including providing to the pooled plan provider any disclosures or other information that the Secretary may require or that the pooled plan provider otherwise determines are necessary to administer the plan or to allow the plan to meet IRC and ERISA requirements,
- Registers with the Secretary as a pooled plan provider and provides any other information that the Secretary may require, before beginning operations as a pooled plan provider,
- Acknowledges in writing its status as a named fiduciary under ERISA and as the plan administrator, and
- Is responsible for ensuring that all persons who handle plan assets or are plan fiduciaries are bonded in accordance with ERISA requirements.

The proposal specifies that the Secretary may perform audits, examinations, and investigations of pooled plan providers as may be necessary to enforce and carry out the purposes of the proposal.

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<sup>73</sup> Within the meaning of ERISA section 402(a)(2).

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In addition, the proposal provides that in determining whether a person meets the requirements to be a pooled plan provider with respect to any plan, all persons who perform services for the plan and who are treated as a single employer<sup>74</sup> are treated as one person.

*Plan Sponsor*

The proposal also provides that, except with respect to the administrative duties (as a named fiduciary, as the plan administrator, and as the person responsible for the performance of all administrative duties) for which the pooled plan provider is responsible as described above, each employer in a plan which has a pooled plan provider will be treated as the plan sponsor with respect to the portion of the plan attributable to that employer's employees (or beneficiaries of such employees).

*Guidance*

The proposal directs the Secretary to issue guidance that the Secretary determines appropriate to carry out the proposal, including guidance (1) to identify the administrative duties and other actions required to be performed by a pooled plan provider, (2) that describes the procedures to be taken to terminate a plan that fails to meet the requirements to be a covered multiple employer plan, including the proper treatment of, and actions needed to be taken by, any employer in the plan and plan assets and liabilities attributable to employees of that employer (or beneficiaries of such employees), and (3) to identify appropriate cases in which corrective action will apply with respect to noncompliant employers.

For purposes of (3), the Secretary is to take into account whether the failure of an employer or pooled plan provider to provide any disclosures or other information, or to take any other action, necessary to administer a plan or to allow a plan to meet the IRC requirements for tax-favored treatment, has continued over a period of time that demonstrates a lack of commitment to compliance. An employer or pooled plan provider is not treated as failing to meet a requirement of guidance issued by the Secretary if, before the issuance of such guidance, the employer or pooled plan provider complies in good faith with a reasonable interpretation of the proposals to which the guidance relates.

The proposal also directs the Secretary to publish model plan language that meets the IRC and ERISA requirements under the proposal and that may be adopted in order to be treated as a pooled employer plan under ERISA.

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<sup>74</sup> Under subsection (b), (c), (m), or (o) of IRC section 414.



## Pooled Employer Plans under ERISA

### *In General*

As described above, under the proposal, a pooled employer plan is treated for purposes of ERISA as a single plan that is a multiple employer plan. A “pooled employer plan” is defined as a plan (1) that is an individual account plan established or maintained for the purpose of providing benefits to the employees of two or more employers, (2) that is a qualified retirement plan or an IRA plan, and (3) the terms of which meet the requirements described below. A pooled employer plan does not include a plan maintained by employers that have a common interest other than having adopted the plan.

In order for a plan to be a pooled employer plan, the plan terms must—

- Designate a pooled plan provider and provide that the pooled plan provider is a named fiduciary of the plan,
- Designate one or more trustees (other than an employer in the plan)<sup>75</sup> to be responsible for collecting contributions to, and holding the assets of, the plan, and require the trustees to implement written contribution collection procedures that are reasonable, diligent, and systematic,
- Provide that each employer in the plan retains fiduciary responsibility for the selection and monitoring, in accordance with ERISA fiduciary requirements, of the person designated as the pooled plan provider and any other person who is also designated as a named fiduciary of the plan, and, to the extent not otherwise delegated to another fiduciary by the pooled plan provider (and subject to the ERISA rules relating to self-directed investments), the investment and management of the portion of the plan's assets attributable to the employees of that employer (or beneficiaries of such employees) in the plan,
- Provide that employers in the plan, and participants and beneficiaries, are not subject to unreasonable restrictions, fees, or penalties with regard to ceasing participation, receipt of distributions, or otherwise transferring assets of the plan in accordance with applicable rules for plan mergers and transfers,
- Require the pooled plan provider to provide to employers in the plan any disclosures or other information that the Secretary of Labor may require, including any disclosures or other information to facilitate the selection or any monitoring of the pooled plan provider by employers in the plan, and require each employer in the plan to take any actions that the Secretary of Labor or pooled plan provider determines are necessary

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<sup>75</sup> Any trustee must meet the requirements under the IRC to be an IRA trustee.

to administer the plan or to allow for the plan to meet the ERISA and IRC requirements applicable to the plan, including providing any disclosures or other information that the Secretary of Labor may require or that the pooled plan provider otherwise determines are necessary to administer the plan or to allow the plan to meet such ERISA and IRC requirements, and

- Provide that any disclosure or other information required to be provided as described above may be provided in electronic form and will be designed to ensure only reasonable costs are imposed on pooled plan providers and employers in the plan.

In the case of a fiduciary of a pooled employer plan or a person handling assets of a pooled employer plan, the maximum bond amount under ERISA is \$1 million.

The term “pooled employer plan” does not include a multiemployer plan. Such term also does not include a plan established before the date of enactment of the Setting Every Community Up for Retirement Enhancement Act of 2019 unless the plan administrator elects to have the plan treated as a pooled employer plan and the plan meets the ERISA requirements applicable to a pooled employer plan established on or after such date.

#### *Pooled Plan Provider*

The definition of pooled plan provider for ERISA purposes is generally similar to the definition under the IRC portion of the proposal, described above.<sup>76</sup> The ERISA definition requires a person to register as a pooled plan provider with the Secretary of Labor and provide any other information that the Secretary of Labor may require before beginning operations as a pooled plan provider.

The proposal specifies that the Secretary of Labor may perform audits, examinations, and investigations of pooled plan providers as may be necessary to enforce and carry out the purposes of the proposal.

#### *Plan Sponsor*

The proposal also provides that except with respect to the administrative duties (as a named fiduciary, as the plan administrator, and as the person responsible for the performance of all administrative duties) for which the pooled plan provider is responsible as described above, each employer in a pooled employer plan will be treated as the plan sponsor with respect to the portion of

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<sup>76</sup> In determining whether a person meets the requirements to be a pooled plan provider with respect to a plan, all persons who perform services for the plan and who are treated as a single employer under subsection (b), (c), (m), or (o) of IRC section 414 are treated as one person.

the plan attributable to that employer's employees (or beneficiaries of such employees).

#### *Guidance*

The proposal directs the Secretary of Labor to issue guidance that such Secretary determines appropriate to carry out the proposal, including guidance (1) to identify the administrative duties and other actions required to be performed by a pooled plan provider, and (2) that requires, in appropriate cases of a noncompliant employer, plan assets attributable to employees of the noncompliant employer (or beneficiaries of such employees) to be transferred to a plan maintained only by that employer (or its successor), to a tax-favored retirement plan for each individual whose account is transferred, or to any other arrangement that the Secretary of Labor determines in the guidance is appropriate,<sup>77</sup> and the noncompliant employer (and not the plan with respect to which the failure occurred or any other employer in the plan) to be liable for any plan liabilities attributable to employees of the noncompliant employer (or beneficiaries of such employees), except to the extent provided in the guidance.

For purposes of (2), the Secretary of Labor is to take into account whether the failure of an employer or pooled plan provider to provide any disclosures or other information, or to take any other action, necessary to administer a plan or to allow a plan to meet the requirements of ERISA and the IRC requirements for tax-favored treatment, has continued over a period of time that demonstrates a lack of commitment to compliance. An employer or pooled plan provider is not treated as failing to meet a requirement of guidance issued by the Secretary if, before the issuance of such guidance, the employer or pooled plan provider complies in good faith with a reasonable interpretation of the proposals to which the guidance relates.

#### *Form 5500 Reporting*

Under the proposal, the Form 5500 filing for a multiple employer plan (including a pooled employer plan) must include a list of the employers in the plan, a good faith estimate of the percentage of total contributions made by such employers during the plan year, and the aggregate account balances attributable to each employer in the plan (determined as the sum of the account balances of the employees of each employer (and the beneficiaries of such employees)); and with respect to a pooled employer plan, the

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<sup>77</sup> The Secretary of Labor may waive the requirement to transfer assets to another plan or arrangement in appropriate circumstances if the Secretary of Labor determines it is in the best interests of the employees of the noncompliant employer (and the beneficiaries of such employees) to retain the assets in the pooled employer plan.

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identifying information for the person designated under the terms of the plan as the pooled plan provider. In addition, the proposal adds to the list of pension plans to which simplified reporting may be prescribed by the Secretary of Labor, a multiple employer plan that covers fewer than 1,000 participants, but only if no single employer in the plan has 100 or more participants covered by the plan.

Effective Date

The provision applies to plan years beginning after December 31, 2020, including reporting for purposes of Forms 5500 for plan years beginning after December 31, 2020.

California Law (R&TC sections 17501 and 24601)

California’s PITL and CTL generally conform by reference to the federal IRA rules under IRC sections 408 and 413 as of the “specified date” of January 1, 2015.<sup>78,79</sup> However, the PITL and CTL additionally provide that federal changes to IRC sections 408 and 413 apply without regard to taxable year to the same extent as applicable for federal income tax purposes.<sup>80</sup> In other words, the PITL and CTL automatically conform to federal changes made to IRC sections 408 and 413. As a result, the federal relief from the “one bad apple” rule for certain plans (referred to herein as “covered multiple employer plans”) automatically applies under California law.

Impact on California Revenue

Baseline.

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<u>Section</u>	<u>Section Title</u>
102	Increase in 10 Percent Cap for Automatic Enrollment Safe Harbor after First Plan Year

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<sup>78</sup> R&TC sections 17501(a) and 24601(a) conform to Subchapter D of Chapter 1 of Subtitle A of the IRC (consisting of IRC sections 401 to 436), relating to deferred compensation, except as otherwise provided.

<sup>79</sup> R&TC sections 17024.5 and 23051.5.

<sup>80</sup> R&TC sections 17501(b) and 24601(b).

## Background

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>81</sup>

### IRC Section 401(k) Plans

A qualified defined contribution plan may include a qualified cash or deferred arrangement, under which employees may elect to have contributions made to the plan (referred to as elective deferrals) rather than receive the same amount as current compensation (referred to as an IRC section 401(k) plan). The maximum annual amount of elective deferrals that can be made by an employee for a year is \$19,000 (for 2019) or, if less, the employee's compensation. For an employee who attains age 50 by the end of the year, the dollar limit on elective deferrals is increased by \$6,000 (for 2019) (called catch-up contributions). An employee's elective deferrals must be fully vested. An IRC section 401(k) plan may also provide for employer matching and nonelective contributions.

### Automatic Enrollment

An IRC section 401(k) plan must provide each eligible employee with an effective opportunity to make or change an election to make elective deferrals at least once each plan year. Whether an employee has an effective opportunity is determined based on all the relevant facts and circumstances, including the adequacy of notice of the availability of the election, the period of time during which an election may be made, and any other conditions on elections.

IRC section 401(k) plans are generally designed so that an employee will receive cash compensation unless the employee affirmatively elects to make elective deferrals to the IRC section 401(k) plan. Alternatively, a plan may provide that elective deferrals are made at a specified rate (referred to as a "default rate") when an employee becomes eligible to participate unless the employee elects otherwise (that is, affirmatively elects not to make contributions or to make contributions at a different rate). This plan design is referred to as automatic enrollment.

### Nondiscrimination Test and Automatic Enrollment Safe Harbor

An annual nondiscrimination test, called the actual deferral percentage test (the ADP test) applies to elective deferrals under an IRC section 401(k) plan.

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<sup>81</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, pp. 15-16.

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The ADP test generally compares the average rate of deferral for highly compensated employees to the average rate of deferral for nonhighly compensated employees and requires that the average deferral rate for highly compensated employees not exceed the average rate for nonhighly compensated employees by more than certain specified amounts. If a plan fails to satisfy the ADP test for a plan year based on the deferral elections of highly compensated employees, the plan is permitted to distribute deferrals to highly compensated employees (excess deferrals) in a sufficient amount to correct the failure. The distribution of the excess deferrals must be made by the close of the following plan year.

The ADP test is deemed to be satisfied if an IRC section 401(k) plan includes certain minimum matching or nonelective contributions under either of two plan designs (401(k) safe harbor plan), as well as certain required rights and features and satisfies a notice requirement. One type of 401(k) safe harbor includes automatic enrollment.

An automatic enrollment safe harbor plan must provide that, unless an employee elects otherwise, the employee is treated as electing to make elective deferrals at a default rate equal to a percentage of compensation as stated in the plan and at least (1) three percent of compensation for the first year the deemed election applies to the participant, (2) four percent during the second year, (3) five percent during the third year, and (4) six percent during the fourth year and thereafter. Although an automatic enrollment safe harbor plan generally may provide for default rates higher than these minimum rates, the default rate cannot exceed 10 percent for any year.

#### New Federal Law (IRC section 401(k))

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>82</sup>

Under the proposal, the 10-percent limitation on the default rates under an automatic enrollment safe harbor plan is increased to 15 percent after the first year that an employee's deemed election applies.

#### Effective Date

The provision applies to plan years beginning after December 31, 2019.

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<sup>82</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, page 16.

California Law (R&TC sections 17501 and 24601)

California's PITL and CTL generally conform by reference to the federal IRA rules under IRC section 401 as of the "specified date" of January 1, 2015.<sup>83,84</sup> However, the PITL and CTL additionally provide that federal changes to IRC section 401 apply without regard to taxable year to the same extent as applicable for federal income tax purposes.<sup>85</sup> In other words, the PITL and CTL automatically conform to federal changes made to IRC section 401. As a result, the federal increase in the 10 percent cap for an automatic enrollment safe harbor plan after the first plan year automatically applies under California law.

Impact on California Revenue

Baseline.

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<sup>83</sup> R&TC sections 17501(a) and 24601(a) conform to Subchapter D of Chapter 1 of Subtitle A of the IRC (consisting of IRC sections 401 to 436), relating to deferred compensation, except as otherwise provided.

<sup>84</sup> R&TC sections 17024.5 and 23051.5.

<sup>85</sup> R&TC sections 17501(b) and 24601(b).



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<u>Section</u>	<u>Section Title</u>
103	Rules Relating to Election of Safe Harbor 401(K) Status

Background

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>86</sup>

IRC Section 401(k) Plans

A qualified defined contribution plan may include a qualified cash or deferred arrangement, under which employees may elect to have contributions made to the plan (referred to as elective deferrals) rather than receive the same amount as current compensation (referred to as a IRC section 401(k) plan).<sup>87</sup> The maximum annual amount of elective deferrals that can be made by an employee for a year is \$19,000 (for 2019) or, if less, the employee's compensation.<sup>88</sup> For an employee who attains age 50 by the end of the year, the dollar limit on elective deferrals is increased by \$6,000 (for 2019) (called catch-up contributions).<sup>89</sup> An employee's elective deferrals must be fully vested. An IRC section 401(k) plan may also provide for employer matching and nonelective contributions.

Automatic Enrollment

An IRC section 401(k) plan must provide each eligible employee with an effective opportunity to make or change an election to make elective deferrals at least once each plan year.<sup>90</sup> Whether an employee has an effective opportunity is determined based on all the relevant facts and circumstances, including the adequacy of notice of the availability of the election, the period of time during which an election may be made, and any other conditions on elections.

IRC section 401(k) plans are generally designed so that an employee will receive cash compensation unless the employee affirmatively elects to make

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<sup>86</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, pp. 17-20.

<sup>87</sup> Elective deferrals generally are made on a pretax basis and distributions attributable to elective deferrals are includible in income. However, an IRC section 401(k) plan is permitted to include a "qualified Roth contribution program" that permits a participant to elect to have all or a portion of the participant's elective deferrals under the plan treated as after-tax Roth contributions. Certain distributions from a designated Roth account are excluded from income, even though they include earnings not previously taxed.

<sup>88</sup> IRC section 402(g).

<sup>89</sup> IRC section 414(v).

<sup>90</sup> Treas. Reg. section 1.401(k)-1(e)(2)(ii).



elective deferrals to the IRC section 401(k) plan. Alternatively, a plan may provide that elective deferrals are made at a specified rate when an employee becomes eligible to participate unless the employee elects otherwise (that is, affirmatively elects not to make contributions or to make contributions at a different rate). This plan design is referred to as automatic enrollment.

## Nondiscrimination Test

### *General Rule and Design-Based Safe Harbors*

An annual nondiscrimination test, the ADP test, applies to elective deferrals under an IRC section 401(k) plan.<sup>91</sup> The ADP test generally compares the average rate of deferral for highly compensated employees to the average rate of deferral for nonhighly compensated employees and requires that the average deferral rate for highly compensated employees not exceed the average rate for nonhighly compensated employees by more than certain specified amounts. If a plan fails to satisfy the ADP test for a plan year based on the deferral elections of highly compensated employees, the plan is permitted to distribute deferrals to highly compensated employees (excess deferrals) in a sufficient amount to correct the failure. The distribution of the excess deferrals must be made by the close of the following plan year.<sup>92</sup>

The ADP test is deemed to be satisfied if an IRC section 401(k) plan includes certain minimum matching or nonelective contributions under either of two plan designs (401(k) safe harbor plan), described below, as well as certain required rights and features and satisfies a notice requirement.<sup>93</sup>

### *Safe Harbor Contributions*

Under one type of 401(k) safe harbor plan (basic 401(k) safe harbor plan), the plan either (1) satisfies a matching contribution requirement (matching contribution basic 401(k) safe harbor plan) or (2) provides for a nonelective contribution to a defined contribution plan of at least three percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the plan (nonelective basic 401(k) safe harbor plan). The matching contribution requirement under the matching contribution basic 401(k) safe harbor requires a matching contribution equal to at least 100 percent of elective contributions of the employee for contributions

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<sup>91</sup> IRC section 401(k)(3).

<sup>92</sup> IRC section 401(k)(8).

<sup>93</sup> IRC sections 401(k)(12) and (13). If certain additional requirements are met, matching contributions under IRC section 401(k) safe harbor plan may also satisfy a nondiscrimination test applicable under IRC section 401(m).

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not in excess of three percent of compensation, and 50 percent of elective contributions for contributions that exceed three percent of compensation but do not exceed five percent, for a total matching contribution of up to four percent of compensation. The required matching contributions and the three percent nonelective contribution under the basic 401(k) safe harbor must be immediately nonforfeitable (that is, 100 percent vested) when made.

Another safe harbor applies for an IRC section 401(k) plan that include automatic enrollment (automatic enrollment 401(k) safe harbor). Under an automatic enrollment 401(k) safe harbor, unless an employee elects otherwise, the employee is treated as electing to make elective deferrals equal to a percentage of compensation as stated in the plan, not in excess of 10 percent and at least (1) three percent of compensation for the first year the deemed election applies to the participant, (2) four percent during the second year, (3) five percent during the third year, and (4) six percent during the fourth year and thereafter.<sup>94</sup> Under the automatic enrollment 401(k) safe harbor, the matching contribution requirement is 100 percent of elective contributions of the employee for contributions not in excess of one percent of compensation, and 50 percent of elective contributions for contributions that exceed one percent of compensation but do not exceed six percent, for a total matching contribution of up to 3.5 percent of compensation (matching contribution automatic enrollment 401(k) safe harbor). The rate of nonelective contribution under the automatic enrollment 401(k) safe harbor plan is three percent, as under the basic 401(k) safe harbor (nonelective contribution automatic enrollment 401(k) safe harbor). However, under the automatic enrollment 401(k) safe harbors, the matching and nonelective contributions are allowed to become 100 percent vested only after two years of service (rather than being required to be immediately vested when made).

#### *Safe Harbor Notice*

The notice requirement for a 401(k) safe harbor plan is satisfied if each employee eligible to participate is given, within a reasonable period before any year, written notice of the employee's rights and obligations under the arrangement and the notice meets certain content and timing requirements (safe harbor notice). To meet the content requirements, a safe harbor notice must be sufficiently accurate and comprehensive to inform an employee of the employee's rights and obligations under the plan, and be written in a manner calculated to be understood by the average employee eligible to

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<sup>94</sup> These automatic increases in default contribution rates are required for plans using the safe harbor. Revenue Ruling [Rev. Rul.] 2009-30, 2009-39 I.R.B. 391, provides guidance for including automatic increases in other plans using automatic enrollment, including under a plan that includes an eligible automatic contribution arrangement.

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participate in the plan. A safe harbor notice must provide certain information, including the plan's safe harbor contributions, any other plan contributions, the type and amount of compensation that may be deferred under the plan, how to make cash or deferred elections, the plan's withdrawal and vesting provisions, and specified contact information. In addition, a safe harbor notice for an automatic enrollment 401(k) safe harbor must describe certain additional information items, including the deemed deferral elections under the plan if the employee does not make an affirmative election and how contributions will be invested.

#### Delay in Adopting Nonelective 401(k) Safe Harbor

Generally the plan provisions for the requirements that must be satisfied to be a 401(k) safe harbor plan must be adopted before the first day of the plan year and remain in effect for an entire 12-month plan year. However, in the case of a nonelective 401(k) safe harbor plan (but not the matching contribution 401(k) safe harbor), a plan may be amended after the first day of the plan year but no later than 30 days before the end of the plan year to adopt the safe harbor plan provisions including providing the 3 percent of compensation nonelective contribution. The plan must also provide a contingent and follow-up notice. The contingent notice must be provided before the beginning of the plan year and specify that the plan may be amended to include the safe harbor nonelective contribution and, if it is so amended, a follow-up notice will be provided.

If the plan is amended, the follow-up notice must be provided no later than 30 days before the end of the plan year stating that the safe harbor nonelective contribution will be provided."

#### New Federal Law (IRC section 401(k))

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>95</sup>

##### In General

The proposal makes a number of changes to the rules for the nonelective contribution 401(k) safe harbor.

##### Elimination of Notice Requirement

The proposal eliminates the safe harbor notice requirement with respect to nonelective 401(k) safe harbor plans. However, the general rule under present

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<sup>95</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, page 20.

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law requiring an IRC section 401(k) plan to provide each eligible employee with an effective opportunity to make or change an election to make elective deferrals at least once each plan year still applies. As described above, relevant factors used in determining if this requirement is satisfied include the adequacy of notice of the availability of the election and the period of time during which an election may be made.

**Delay in Adopting Provisions for Nonelective 401(k) Safe Harbor**

Under the proposal, a plan can be amended to become a nonelective 401(k) safe harbor plan for a plan year (that is, amended to provide the required nonelective contributions and thereby satisfy the safe harbor requirements) at any time before the 30th day before the close of the plan year.

Further, the proposal allows a plan to be amended after the 30th day before the close of the plan year to become a nonelective contribution 401(k) safe harbor plan for the plan year if (1) the plan is amended to provide for a nonelective contribution of at least four percent of compensation (rather than at least three percent) for all eligible employees for that plan year and (2) the plan is amended no later than the last day for distributing excess contributions for the plan year (generally, by the close of following plan year)."

Effective Date

The provision applies to plan years beginning after December 31, 2019.

California Law (R&TC sections 17501 and 24601)

California's PITL and CTL generally conforms by reference to the federal IRA rules under IRC section 401 as of the "specified date" of January 1, 2015.<sup>96,97</sup> However, the PITL and CTL additionally provide that federal changes to IRC section 401 apply without regard to taxable year to the same extent as applicable for federal income tax purposes.<sup>98</sup> In other words, the PITL and CTL automatically conform to federal changes made to IRC section 401. As a result, the federal changes made by this provision to the rules for the nonelective contribution 401(k) safe harbor automatically apply under California law.

Impact on California Revenue

Baseline.

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<sup>96</sup> R&TC sections 17501(a) and 24601(a) conform to Subchapter D of Chapter 1 of Subtitle A of the IRC (consisting of IRC sections 401 to 436), relating to deferred compensation, except as otherwise provided.

<sup>97</sup> R&TC sections 17024.5 and 23051.5.

<sup>98</sup> R&TC sections 17501(b) and 24601(b).

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<u>Section</u>	<u>Section Title</u>
104	Increase in Credit Limitation for Small Employer Pension Plan Startup Costs

Background

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>99</sup>

A nonrefundable income tax credit is available for qualified startup costs of an eligible small employer that adopts a new qualified retirement plan, SIMPLE IRA plan, or SEP (referred to as an eligible employer plan), provided that the plan covers at least one nonhighly compensated employee.<sup>100</sup> Qualified startup costs are expenses connected with the establishment or administration of the plan or retirement-related education for employees with respect to the plan. The credit is the lesser of (1) a flat dollar amount of \$500 per year or (2) 50 percent of the qualified startup costs. The credit applies for up to three years beginning with the year the plan is first effective, or, at the election of the employer, with the year preceding the first plan year.

An eligible employer is an employer that, for the preceding year, had no more than 100 employees, each with compensation of \$5,000 or more. In addition, the employer must not have had a plan covering substantially the same employees as the new plan during the three years preceding the first year for which the credit would apply. Members of controlled groups and affiliated service groups are treated as a single employer for purposes of these requirements.<sup>101</sup> All eligible employer plans of an employer are treated as a single plan.

No deduction is allowed for the portion of qualified startup costs paid or incurred for the taxable year equal to the amount of the credit.

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<sup>99</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, page 21.

<sup>100</sup> A nonhighly compensated employee is an employee who is not a highly compensated employee as defined under IRC section 414(q).

<sup>101</sup> IRC sections 52 (a) or (b) and 414(m) or (o).

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New Federal Law (IRC section 45E)

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>102</sup>

The proposal changes the calculation of the flat dollar amount limit on the credit. The flat dollar amount for a taxable year is the greater of (1) \$500 or (2) the lesser of (a) \$250 multiplied by the number of nonhighly compensated employees of the eligible employer who are eligible to participate in the plan or (b) \$5,000. As under present law, the credit applies for up to three years.

Effective Date

The provision applies to taxable years beginning after December 31, 2019.

California Law (None)

California does not conform to the federal small employer pension plan startup costs credit.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
105	Small Employer Automatic Enrollment Credit

Background

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>103</sup>

A nonrefundable income tax credit is available for qualified startup costs of an eligible small employer that adopts a new qualified retirement plan, SIMPLE IRA plan or SEP (referred to as an eligible employer plan), provided that the plan covers at least one nonhighly compensated employee.<sup>104</sup> Qualified startup costs are expenses connected with the establishment or administration of the

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<sup>102</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, page 21.

<sup>103</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, page 22.

<sup>104</sup> IRC section 45E. A nonhighly compensated employee is an employee who is not a highly compensated employee as defined under IRC section 414(q).

plan or retirement-related education for employees with respect to the plan. The credit is the lesser of (1) a flat dollar amount of \$500 per year or (2) 50 percent of the qualified startup costs.

The credit applies for up to three years beginning with the year the plan is first effective, or, at the election of the employer, with the year preceding the first plan year. An eligible employer is an employer that, for the preceding year, had no more than 100 employees with compensation of \$5,000 or more. In addition, the employer must not have had a plan covering substantially the same employees as the new plan during the three years preceding the first year for which the credit would apply. Members of controlled groups and affiliated service groups are treated as a single employer for purposes of these requirements.<sup>105</sup> All eligible employer plans of an employer are treated as a single plan. No deduction is allowed for the portion of qualified startup costs paid or incurred for the taxable year equal to the amount of the credit.

#### Automatic Enrollment

A qualified defined contribution plan may include a qualified cash or deferred arrangement under which employees may elect to have plan contributions (elective deferrals) made rather than receive cash compensation (commonly called an IRC section 401(k) plan). A SIMPLE IRA plan is an employer-sponsored retirement plan funded with individual retirement arrangements (IRAs) that also allows employees to make elective deferrals.<sup>106</sup> IRC section 401(k) plans and SIMPLE IRA plans may be designed so that the employee will receive cash compensation unless the employee affirmatively elects to make elective deferrals to the plan.

Alternatively, a plan may provide that elective deferrals are made at a specified rate (when the employee becomes eligible to participate) unless the employee elects otherwise (i.e., affirmatively elects not to make contributions or to make contributions at a different rate). This alternative plan design is referred to as automatic enrollment.

#### General Business Credit (GBC)

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 tax 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

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<sup>105</sup> IRC sections 52 (a) or (b) and 414(m) or (o).

<sup>106</sup> IRC section 408(p).



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the taxable year, the current year GBC, and GBC carrybacks to the taxable year.<sup>107</sup>

New Federal Law (IRC sections 38 and 45T)

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>108</sup>

In general, the credit is treated as a GBC, and an eligible employer is allowed a credit of \$500 per year for up to three years for startup costs for new IRC section 401(k) plans and SIMPLE IRA plans that include automatic enrollment, in addition to the plan startup credit allowed under present law. An eligible employer is also allowed a credit of \$500 per year for up to three years if it converts an existing plan to an automatic enrollment design.

Effective Date

The provision applies to taxable years beginning after December 31, 2019.

California Law (None)

California does not conform to the new federal small employer automatic enrollment credit or to existing federal GBC provisions.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
106	Certain Taxable Non-tuition Fellowship and Stipend Payments Treated as Compensation for IRA Purposes

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<sup>107</sup> IRC section 38(a). Also, IRC section 38(b) contains a list of the component credits of the current year business credit.

<sup>108</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, page 23.



## Background

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>109</sup>

There are two general types of individual retirement arrangements (IRAs): traditional IRAs and Roth IRAs.<sup>110</sup> The total amount that an individual may contribute to one or more IRAs for a year is generally limited to the lesser of: (1) a dollar amount (\$6,000 for 2019); and (2) the amount of the individual's compensation that is includible in gross income for the year.<sup>111</sup> In the case of an individual who has attained age 50 by the end of the year, the dollar amount is increased by \$1,000. In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses that is includible in gross income is at least equal to the contributed amount.

An individual may make contributions to a traditional IRA (up to the contribution limit) without regard to his or her AGI. An individual may deduct his or her contributions to a traditional IRA if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. If an individual or the individual's spouse is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers with AGI over certain levels.<sup>112</sup> Individuals with AGI below certain levels may make contributions to a Roth IRA (up to the contribution limit).<sup>113</sup> Contributions to a Roth IRA are not deductible.

As described above, an individual's IRA contributions generally cannot exceed the amount of his or her compensation that is includible in gross income. Subject to the rule for spouses, described above, an individual who has no includible compensation income generally is not eligible to make IRA contributions, even if the individual has other income that is includible in gross income.<sup>114</sup>

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<sup>109</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, page 24.

<sup>110</sup> IRC sections 408 and 408A.

<sup>111</sup> IRC sections 219(b)(2) and (5), as referenced in IRC sections 408(a)(1) and (b)(2)(B) and 408A(c)(2). Under IRC section 4973, IRA contributions in excess of the applicable limit are generally subject to an excise tax of six percent per year until withdrawn.

<sup>112</sup> IRC section 219(g).

<sup>113</sup> IRC section 408A(c)(3).

<sup>114</sup> Under a special rule in IRC section 219(f)(1), alimony that is includible in gross income under IRC section 71 is treated as compensation for IRA contribution purposes.

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New Federal Law (IRC section 219(f))

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>115</sup>

Under the provision, an amount includible in an individual's income and paid to the individual to aid the individual in the pursuit of graduate or postdoctoral study<sup>116</sup> (such as a fellowship, stipend, or similar amount) is treated as compensation for purposes of IRA contributions.

Effective Date

The provision applies to taxable years beginning after December 31, 2019.

California Law (R&TC section 17203)

Under R&TC section 17203, California law specifically provides that any references to "compensation" or "earned income" for purposes of computing federal limitations on the deductions for an IRA, shall apply also to California. Thus, the changes to IRC section 219 that amends the term "compensation" to include aid to the individual in the pursuit of graduate or postdoctoral study, automatically apply under California law.

Impact on California Revenue

Baseline.

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<u>Section</u>	<u>Section Title</u>
107	Repeal of Maximum Age for Traditional IRA Contributions

Background

Maximum Age for Traditional IRA Contributions

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<sup>115</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, pages 24 and 25.

<sup>116</sup> The Joint Committee on Taxation report states, "...the pursuit of graduate or postdoctoral study or research." The words "or research" are stricken here because they are not included in the federal act.

Further Consolidations Appropriations Act, 2020  
Public Law 116-94, December 20, 2019

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>117</sup>

An individual may make deductible contributions to a traditional IRA up to the IRA contribution limit if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan.<sup>118</sup> If an individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers with AGI for the taxable year over certain indexed levels.<sup>119</sup> To the extent an individual cannot or does not make deductible contributions to a traditional IRA, the individual may make nondeductible contributions to a traditional IRA (without regard to AGI limits). Alternatively, subject to AGI limits, an individual may make nondeductible contributions to a Roth IRA.<sup>120</sup>

An individual who has attained age 70½ by the close of a year is not permitted to make contributions to a traditional IRA.<sup>121</sup> This restriction does not apply to contributions to a Roth IRA.<sup>122</sup> In addition, employees over age 70½ are not precluded from contributing to employer-sponsored plans.

#### IRA Qualified Charitable Distribution Exclusion

A distribution from an IRA that is donated to a charity may be excluded from income if the distribution is a qualified charitable distribution (QCD)<sup>123</sup> that does not exceed \$100,000 during a taxable year. In general, a QCD is a distribution from an IRA account that is done (1) on or after the date that the individual for whose benefit the plan is maintained has attained age 70½, and (2) directly by the IRA trustee to certain charitable organizations.<sup>124</sup> QCDs may not be deducted as a charitable deduction, and are not subject to the general percentage limitations applicable to charitable contributions.

#### New Federal Law (IRC sections 219(d) and 408(d)(8))

The provision repeals the prohibition on contributions to a traditional IRA by an individual who has attained age 70½. The provision also reduces the amount of

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<sup>117</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, page 26.

<sup>118</sup> IRC section 219.

<sup>119</sup> IRC section 219(g).

<sup>120</sup> IRC section 408(o). The annual contribution limit for IRAs is coordinated so that the maximum amount that can be contributed to all of an individual's IRAs (both traditional and Roth) for a taxable year is the lesser of a certain dollar amount (\$6,000 for 2019) or the individual's compensation.

<sup>121</sup> IRC section 219(d)(1).

<sup>122</sup> IRC section 408A(c)(4).

<sup>123</sup> IRC section 408(d)(8)(A).

<sup>124</sup> Under IRC section 170(b)(1)(A), other than IRC section 509(a)(3) private foundation or an IRC section 509(a)(3) donor advised fund.

QCDs that may be excluded from gross income by the excess of:

1. The aggregate amount of IRA deductions allowed to the taxpayer for all taxable years ending on or after the date the taxpayer attains age 70½, over.
2. The aggregate amount of the reductions for all taxable years preceding the current taxable year.

### Effective Dates

The amendments to IRC section 219 apply to contributions made for taxable years beginning after December 31, 2019, and the amendments to IRC section 408 apply to distributions made for taxable years beginning after December 31, 2019.

### California Law (R&TC sections 17201, 17203, 17501, and 24601)

#### *Maximum Age for Traditional IRA Contributions*

California conforms, under the PITL, to the allowance of retirement savings deductions under IRC section 219, as of the “specified date” of January 1, 2015,<sup>125</sup> with the modification that any references to “compensation” or “earned income” for purposes of computing federal limitations on the deductions for an IRA, shall apply also to California for the same taxable year as federal.

Thus, California does not conform to the repeal of the prohibition on contributions to a traditional IRA by an individual who has attained age 70½ because the provision does not reference limitations based on “compensation” or “earned income.”

#### *IRA Qualified Charitable Distribution Exclusion*

California’s PITL and CTL generally conform by reference to the federal IRA rules under IRC section 408 as of the “specified date” of January 1, 2015.<sup>126,127</sup> However, the PITL and CTL additionally provide that federal changes to IRC section 408 apply without regard to taxable year to the same extent as applicable for federal income tax purposes.<sup>128</sup> In other words, the PITL and CTL automatically conform to federal changes made to IRC section 408. As a result, the federal reduction of the amount of QCD distributions that are excludable automatically applies under California law.

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<sup>125</sup> R&TC section 17024.5.

<sup>126</sup> R&TC sections 17501(a) and 23601(a) conform to Subchapter D of Chapter 1 of Subtitle A of the IRC (consisting of IRC sections 401 to 436), relating to deferred compensation, except as otherwise provided.

<sup>127</sup> R&TC sections 17024.5 and 23051.5.

<sup>128</sup> R&TC sections 17501(b) and 23601(b).

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Impact on California Revenue

Estimated Conformity Revenue Impact of  
Repeal of Maximum Age for Traditional IRA Contributions

For Taxable Years Beginning On or After January 1, 2020  
Enactment Assumed After June 30, 2020

2019-2020	2020-2021	2021-2022	2022-2023
N/A	-\$600,000	-\$450,000	-\$600,000

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<u>Section</u>	<u>Section Title</u>
108	Qualified Employer Plans Prohibited from Making Loans through Credit Cards and Other Similar Arrangements

Background

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>129</sup>

Employer-sponsored retirement plans may provide loans to participants. Unless the loan satisfies certain requirements in both form and operation, the amount of a retirement plan loan is a deemed distribution from the retirement plan. Among the requirements that the loan must satisfy are that the loan amount must not exceed the lesser of 50 percent of the participant's account balance or \$50,000 (generally taking into account outstanding balances of previous loans), and the loan's terms must provide for a repayment period of not more than five years (except for a loan specifically to purchase a home) and for level amortization of loan payments to be made not less frequently than quarterly.<sup>130</sup>

Thus, if an employee stops making payments on a loan before the loan is repaid, a deemed distribution of the outstanding loan balance generally occurs. A deemed distribution of an unpaid loan balance generally is taxed as though an actual distribution occurred, including being subject to a 10-percent early distribution tax, if applicable. A deemed distribution is not eligible for rollover to another eligible retirement plan. Subject to the limit on

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<sup>129</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, page 27.

<sup>130</sup> IRC section 72(p).

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the amount of loans, which precludes any additional loan that would cause the limit to be exceeded, the rules relating to loans do not limit the number of loans an employee may obtain from a plan. Some arrangements have developed under which an employee can access plan loans through the use of a credit card or similar mechanism.

New Federal Law (IRC section 72(p))

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>131</sup>

Under the proposal, a plan loan that is made through the use of a credit card or similar arrangement does not meet the requirements for loan treatment applicable to qualified retirement plans, and is therefore a deemed distribution.

Effective Date

The provision applies to loans made after December 20, 2019.

California Law (R&TC section 17081)

California conforms to IRC section 72(p), relating to loans treated as distributions, as of the “specified date” of January 1, 2015,<sup>132</sup> but does not conform to the federal change prohibiting qualified employer plans from making loans through credit cards and other similar arrangements.

Impact on California Revenue

Estimated Conformity Revenue Impact of Qualified Employer Plans Prohibited from Making Loans through Credit Cards and Other Similar Arrangements

For Taxable Years Beginning On or After January 1, 2020  
Enactment Assumed After June 30, 2020

2019-2020	2020-2021	2021-2022	2022-2023
N/A	Negligible	Negligible	Negligible

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Section      Section Title

<sup>131</sup> Joint Committee on Taxation, Description of the Chairman’s Amendment in the Nature of a Substitute to H.R. 1994, the “Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019,” JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, page 27.

<sup>132</sup> R&TC section 17024.5.

109 Portability of Lifetime Income Options

Background

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>133</sup>

Distribution Restrictions for Accounts under Employer-Sponsored Plans

*Types of Plans and Contributions*

Tax-favored employer-sponsored retirement plans under which individual accounts are maintained for employees include qualified defined contribution plans, tax-deferred annuity plans (referred to as IRC section 403(b) plans), and eligible deferred compensation plans of State and local government employers (referred to as governmental IRC section 457(b) plans).<sup>134</sup>

Contributions to a qualified defined contribution plan or IRC section 403(b) plan may include some or all of the following types of contributions:

- Pretax elective deferrals (that is, pretax contributions made at the election of an employee in lieu of receiving cash compensation),
- After-tax designated Roth contributions (that is, elective deferrals made on an after-tax basis to a Roth account under the plan),
- After-tax employee contributions (other than designated Roth contributions),
- Pretax employer matching contributions (that is, employer contributions made as a result of an employee's elective deferrals, designated Roth contributions, or after-tax contributions), and
- Pretax employer nonelective contributions (that is, employer contributions made without regard to whether an employee makes elective deferrals, designated Roth contributions, or after-tax contributions).

Contributions to a governmental IRC section 457(b) plan generally consist of pretax elective deferrals and, if provided for under the plan, designated Roth contributions.

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<sup>133</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, pp. 28-30.

<sup>134</sup> IRC sections 401(a), 403(a), 403(b), 457(b) and (e)(1)(A).



### *Restrictions on In-Service Distributions*

The terms of an employer-sponsored retirement plan generally determine when distributions are permitted. However, in some cases, statutory restrictions on distributions may apply.

Elective deferrals under a qualified defined contribution plan are subject to statutory restrictions on distribution before severance from employment, referred to as in-service distributions.<sup>135</sup> In-service distributions of elective deferrals (and related earnings) generally are permitted only after attainment of age 59½ or termination of the plan. In-service distributions of elective deferrals (but not related earnings) are also permitted in the case of hardship.<sup>136</sup>

Other distribution restrictions may apply to contributions under certain types of qualified defined contribution plans. A profit-sharing plan generally may allow an in-service distribution of an amount contributed to the plan only after a fixed number of years (not less than two).<sup>137</sup> A money purchase pension plan generally may not allow an in-service distribution before attainment of age 62 (or attainment of normal retirement age under the plan if earlier) or termination of the plan.<sup>138</sup>

Elective deferrals under an IRC section 403(b) plan are subject to in-service distribution restrictions similar to those applicable to elective deferrals under a qualified defined contribution plan, and, in some cases, other contributions to an IRC section 403(b) plan are subject to similar restrictions.<sup>139</sup> Deferrals under a governmental IRC section 457(b) plan are subject to in-service distribution restrictions similar to those applicable to elective deferrals under a qualified defined contribution plan, except that in-service distributions under a governmental IRC section 457(b) plan apply until age 70½ (rather than age 59½).<sup>140</sup>

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<sup>135</sup> IRC section 401(k)(2)(B). Similar restrictions apply to certain other contributions, such as employer matching or nonelective contributions required under the nondiscrimination safe harbors under IRC section 401(k).

<sup>136</sup> The Bipartisan Budget Act of 2018, P.L. No. 115-123 (BBA), amends certain hardship distribution rules applicable to 401(k) plans, effective for plan years beginning after December 31, 2018. One such amendment under BBA section 41114 permits earnings on elective deferrals under an IRC section 401(k) plan, as well as qualified nonelective contributions and qualified matching contributions (and attributable earnings), to be distributed on account of hardship.

<sup>137</sup> Rev. Rul. 71-295, 1971-2 C.B. 184, and Treas. Reg. section 1.401-1(b)(1)(ii). Similar rules apply to a stock bonus plan. Treas. Reg. section 1.401-1(b)(1)(iii).

<sup>138</sup> IRC section 401(a)(36) and Treas. Reg. sections 1.401-1(b)(1)(i) and 1.401(a)-1(b).

<sup>139</sup> IRC sections 403(b)(7)(A)(ii) and 403(b)(11).

<sup>140</sup> IRC section 457(d)(1)(A).



## Distributions and Rollovers

A distribution from an employer-sponsored retirement plan is generally includible in income except for any portion attributable to after-tax contributions, which result in basis.<sup>141</sup> Unless an exception applies, in the case of a distribution before age 59½ from a qualified retirement plan or an IRC section 403(b) plan, any amount included in income is subject to an additional 10-percent tax, referred to as the early withdrawal tax.<sup>142</sup>

A distribution from an employer-sponsored retirement plan generally may be rolled over on a nontaxable basis to another such plan or to an individual retirement arrangement (IRA), either by a direct transfer to the recipient plan or IRA or by contributing the distribution to the recipient plan or IRA within 60 days of receiving the distribution.<sup>143</sup> If the distribution from an employer-sponsored retirement plan consists of property, the rollover is accomplished by a transfer or contribution of the property to the recipient plan or IRA.

## Investment of Accounts under Employer-Sponsored Plans

Qualified defined contribution plans, IRC section 403(b) plans, and governmental IRC section 457(b) plans commonly allow employees to direct the manner in which their accounts are invested. Employees may be given a choice among specified lifetime investments, such as a choice of specified mutual funds, and, in some cases, may be able to direct the investment of their accounts in any product, instrument or investment offered in the market.

The investment options under a particular employer-sponsored retirement plan may change at times.<sup>144</sup> Similarly, a plan that allows employees to direct the investment of their accounts in any product, instrument or investment offered in the market may be amended to limit the investments that can be held in the plan. In these cases, employees may be required to change the investments held within their accounts.

The terms of some investments impose a charge or fee when the investment is liquidated, particularly if the investment is liquidated within a particular period

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<sup>141</sup> IRC sections 402(a), 403(b)(1) and 457(a)(1). Under IRC section 402A(d), a qualified distribution from a designated Roth account under an employer-sponsored plan is not includible in income.

<sup>142</sup> IRC section 72(t).

<sup>143</sup> IRC sections 402(c), 402A(c)(3), 403(b)(8) and 457(e)(16).

<sup>144</sup> In the case of a plan subject to ERISA, a participant's exercise of control over the investment of the assets in his or her account by choosing among the investment options offered under the plan does not relieve a plan fiduciary from the duty to prudently select and monitor the investment options offered to participants. 29 C.F.R. section 2550.404c-1(d)(2)(iv) (2010); *Tibble v. Edison International*, No. 13-550, 135 S. Ct. 1823 (2015). The duty to monitor investment options may result in a change in the options offered.

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after acquisition. For example, a lifetime income product, such as an annuity contract, may impose a surrender charge if the investment is discontinued.

If an employee has to liquidate an investment held in an employer-sponsored retirement plan because of a change in investment options or a limit on investments held in the plan, the employee may be subject to a charge or fee as described above. In addition, restrictions on in-service distributions may prevent the employee from preserving the investment through a rollover.

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

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>145</sup>

Under the proposal, if a lifetime income investment is no longer authorized to be held as an investment option under a qualified defined contribution plan, IRC section 403(b) plan, or governmental IRC section 457(b) plan, except as otherwise provided in guidance, the plan does not fail to satisfy the IRC requirements applicable to the plan solely by reason of allowing (1) qualified distributions of a lifetime income investment, or (2) distributions of a lifetime income investment in the form of a qualified plan distribution annuity contract. Such a distribution must be made within the 90-day period ending on the date when the lifetime income investment is no longer authorized to be held as an investment option under the plan.

For purposes of the proposal, a qualified distribution is a direct trustee-to-trustee transfer to another employer-sponsored retirement plan or IRA.<sup>146</sup> A lifetime income investment is an investment option designed to provide an employee with election rights (1) that are not uniformly available with respect to other investment options under the plan and (2) that are rights to a lifetime income feature available through a contract or other arrangement offered under the plan (or under another employer-sponsored retirement plan or IRA through a direct trustee-to-trustee transfer).

A lifetime income feature is (1) a feature that guarantees a minimum level of income annually (or more frequently) for at least the remainder of the life of the employee or the joint lives of the employee and the employee's designated beneficiary, or (2) an annuity payable on behalf of the employee under which payments are made in substantially equal periodic payments (not less frequently than annually) over the life of the employee or the joint lives of

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<sup>145</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, page 31.

<sup>146</sup> For this purpose, an employer-sponsored retirement plan or IRA means such a plan or IRA that is an eligible retirement plan under IRC section 402(c)(8)(B).

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the employee and the employee's designated beneficiary. Finally, a qualified plan distribution annuity contract is an annuity contract purchased for a participant and distributed to the participant by an employer-sponsored retirement plan or an employer-sponsored retirement plan contract.<sup>147</sup>

Effective Date

The provision applies to plan years beginning after December 31, 2019.

California Law (R&TC sections 17501, 17551, and 24601)

*Qualified Defined Contribution Plans and Tax-Deferred Annuity Plans*

California's PITL and CTL generally conform by reference to the federal qualified defined contribution plan and tax-deferred annuity plan rules under IRC sections 401 and 403 as of the "specified date" of January 1, 2015.<sup>148,149</sup>

However, the PITL and CTL additionally provide that federal changes to IRC sections 401 and 403 apply without regard to taxable year to the same extent as applicable for federal income tax purposes.<sup>150</sup> In other words, the PITL and CTL *automatically conform to federal changes* made to IRC sections 401 and 403. As a result, the federal portability of lifetime income options relating to qualified defined contribution plans and tax-deferred annuity plans automatically apply under California law.

*Deferred Compensation Plans of State and Local Government Employers*

California's PITL generally conforms by reference to the federal rules relating to deferred compensation plans of State and local governments and tax-exempt organizations under IRC sections 457 as of the "specified date" of January 1, 2015.<sup>151,152</sup>

However, the PITL additionally provides that federal changes to IRC section 457 apply, except as otherwise provided, without regard to taxable years to the same

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<sup>147</sup> For this purpose, an employer-sponsored retirement plan contract is an annuity contract distributed from an eligible retirement plan described in IRC section 402(c)(8)(B) other than an IRA or individual retirement annuity.

<sup>148</sup> R&TC sections 17501(a) and 24601(a) conforms to Subchapter D of Chapter 1 of Subtitle A of the IRC (consisting of IRC sections 401 to 436), relating to deferred compensation, except as otherwise provided.

<sup>149</sup> R&TC sections 17024.5 and 23051.5.

<sup>150</sup> R&TC sections 17501(b) and 24601(b).

<sup>151</sup> R&TC section 17551(a) conforms to Subchapter E of Chapter 1 of Subtitle A of the IRC (consisting of IRC sections 441 to 475), relating to accounting period and methods of accounting, except as otherwise provided.

<sup>152</sup> R&TC section 17024.5.

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extent as applicable for federal income tax purposes.<sup>153</sup> The PITL modifies the maximum deferred compensation amount that is excludable under IRC section 457 to the federal amount allowed on January 1, 2010.<sup>154</sup> As a result, to the federal portability of lifetime income options relating to deferred compensation plans of State and local governments automatically apply under California law.

Impact on California Revenue

Baseline.

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<u>Section</u>	<u>Section Title</u>
110	Treatment of Custodial Accounts on Termination of IRC Section 403(b) Plans

Background

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>155</sup>

Tax-Sheltered Annuities (IRC Section 403(b) Plans)

IRC section 403(b) plans are a form of tax-favored employer-sponsored plan that provide tax benefits similar to qualified retirement plans. IRC section 403(b) plans may be maintained only by (1) charitable tax-exempt organizations, and (2) educational institutions of State or local governments (that is, public schools, including colleges and universities). Many of the rules that apply to IRC section 403(b) plans are similar to the rules applicable to qualified retirement plans, including IRC section 401(k) plans. Employers may make nonelective or matching contributions to such plans on behalf of their employees, and the plan may provide for employees to make pretax elective deferrals, designated Roth contributions (held in designated Roth accounts)<sup>156</sup> or other after-tax contributions.

Generally IRC section 403(b) plans provide for contributions toward the purchase of annuity contracts or provide for contributions to be held in custodial accounts for each employee. In the case of contributions to custodial accounts under an IRC section 403(b) plan, the amounts must be

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<sup>153</sup> R&TC section 17551(c)(1).

<sup>154</sup> R&TC section 17551(c)(2).

<sup>155</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, pp. 32-34.

<sup>156</sup> IRC section 402A.

invested only in regulated investment company stock.<sup>157</sup> Contributions to a custodial account are not permitted to be distributed before the employee dies, attains age 59½, has a severance from employment, or, in the case of elective deferrals, encounters financial hardship.

An IRC section 403(b) plan is permitted to contain provision for plan termination and that allow accumulated benefits to be distributed on termination.<sup>158</sup> In order for a plan termination to be effectuated, however, all plan assets must be distributed to participants.

### Rollovers

A distribution from an IRC section 403(b) plan that is an eligible rollover distribution may be rolled over to an eligible retirement plan (which include another 403(b) plan, a qualified retirement plan, and an IRA).<sup>159</sup> The rollover generally can be achieved by direct rollover (direct payment from the distributing plan to the recipient plan) or by contributing the distribution to the eligible retirement plan within 60 days of receiving the distribution (60-day rollover).<sup>160</sup>

Amounts that are rolled over are usually not included in gross income. Generally, a distribution of any portion of the balance to the credit of a participant is an eligible rollover distribution with exceptions, for example, certain periodic payments, required minimum distributions, and hardship distributions.<sup>161</sup>

### Roth Conversions

Distributions from IRC section 403(b) plans may be rolled into a Roth IRA.<sup>162</sup> Distributions from these plans that are rolled over into a Roth IRA and that are not distributions from a designated Roth account must be included in gross income. Further, an IRC section 403(b) plan that allows employees to make

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<sup>157</sup> IRC section 403(b)(7).

<sup>158</sup> Treas. Reg. section 1.403(b)-10(a).

<sup>159</sup> IRC section 403(b)(8). Similar rules apply to distributions from qualified retirement plans and governmental IRC section 457(b) plans.

<sup>160</sup> Under section 402(c)(11), any distribution to a beneficiary other than the participant's surviving spouse is only permitted to be rolled over to an IRA using a direct rollover; 60-day rollovers are not available to nonspouse beneficiaries.

<sup>161</sup> IRC section 402(c)(4). Treas. Reg. section 1.402(c)-1 identifies certain other payments that are not eligible for rollover, including, for example, certain corrective distributions, loans that are treated as deemed distributions under IRC section 72(p), and dividends on employer securities as described in IRC section 404(k).

<sup>162</sup> IRC section 408A(d)(3). Similar rules apply to qualified retirement plans and governmental IRC section 457(b) plans.

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designated Roth contributions may also allow employees to elect to transfer amounts held in accounts that are not designated Roth accounts into designated Roth accounts, but the amount transferred must be included in income as though it were distributed.<sup>163</sup>

#### Approved Nonbank Trustees Required for IRAs

An IRA can be a trust, a custodial account, or an annuity contract. The IRC requires that the trustee or custodian of an IRA be a bank (which is generally subject to federal or state supervision) or an IRS approved nonbank trustee, that an annuity contract be issued by an insurance company (which is subject to State supervision), and that an IRA trust or custodial account be created and organized in the U.S.

In order for a trustee or custodian that is not a bank to be an IRA trustee or custodian, the entity must apply to the IRS for approval. Treas. Reg. list a number of factors that are taken into account in approving an applicant to be a nonbank trustee.<sup>164</sup> The applicant must demonstrate fiduciary ability (ability to act within accepted rules of fiduciary conduct including continuity and diversity of ownership), capacity to account (experience and competence with other activities normally associated with handling of retirement funds), and ability to satisfy other rules of fiduciary conduct which includes a net worth requirement. Because it is an objective requirement that may be difficult for some applicants to satisfy, the net worth requirement is the most significant of the requirements for nonbank trustees.

To be approved, the entity must have a net worth of at least \$250,000 at the time of the application. There is a maintenance rule that varies depending on whether the trustee is an active trustee or a passive trustee and that includes minimum dollar amounts and minimum amounts as a percentage of assets held in fiduciary accounts. A special rule is provided for nonbank trustees that are members of the Security Investor Protection Corporation (SIPC).

#### New Federal Law (IRC section 403(b))

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>165</sup>

Under the proposal, the Secretary is directed to issue guidance within six months after the date of enactment to provide that, if an employer

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<sup>163</sup> IRC section 402A(d)(4). Similar rules apply to qualified retirement plans and governmental IRC section 457(b) plans.

<sup>164</sup> Treas. Reg. section 1.408-2(e).

<sup>165</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, page 34.



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terminates an IRC section 403(b) plan under which amounts are contributed to custodial accounts, the plan administrator or custodian may distribute an individual custodial account in kind to a participant or beneficiary of the plan and the distributed custodial account must be maintained by the custodian on a tax-deferred basis as an IRC section 403(b)(7) custodial account, similar to the treatment of fully-paid individual annuity contracts under Rev. Rul. 2011-7,<sup>166</sup> until amounts are actually paid to the participant or beneficiary. In addition, such guidance must provide that (1) the IRC section 403(b)(7) status of the distributed custodial account is generally maintained if such account thereafter adheres to the requirements of IRC section 403(b) in effect at the time of the account's distribution, and (2) a custodial account is not considered distributed to the participant or beneficiary if the employer has any material retained rights under the account (the employer, however, is not treated as retaining material rights simply because the custodial account was originally opened under a group contract).

The proposal directs such guidance to apply retroactively for taxable years beginning after December 31, 2008.

Effective Date

The provision is effective upon date of enactment.

California Law (R&TC sections 17501 and 24601)

California's PITL and CTL generally conform by reference to the federal rules under IRC section 403(b) as of the "specified date" of January 1, 2015.<sup>167,168</sup> However, the PITL and CTL additionally provide that federal changes to IRC section 403(b) apply without regard to taxable year to the same extent as applicable for federal income tax purposes.<sup>169</sup> In other words, the PITL and CTL automatically conform to federal changes made to IRC section 403(b). As a result, the federal treatment of custodial accounts on termination of IRC section 403(b) plans automatically applies under California law.

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<sup>166</sup> 2011-10 I.R.B. 534 (March 7, 2011).

<sup>167</sup> R&TC sections 17501(a) and 24601(a) conform to Subchapter D of Chapter 1 of Subtitle A of the IRC (consisting of IRC sections 401 to 436), relating to deferred compensation, except as otherwise provided.

<sup>168</sup> R&TC sections 17024.5 and 23051.5.

<sup>169</sup> R&TC sections 17501(b) and 24601(b).

## Impact on California Revenue

Baseline.

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<u>Section</u>	<u>Section Title</u>
111	Clarification of Retirement Income Account Rules Relating to Church-Controlled Organizations

### Background

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>170</sup>

Assets of a tax-sheltered annuity plan (IRC section 403(b) plan), generally must be invested in annuity contracts or mutual funds.<sup>171</sup> However, the restrictions on investments do not apply to a retirement income account, which is a defined contribution program established or maintained by a church, or a convention or association of churches, to provide benefits under the plan to employees of a religious, charitable or similar tax-exempt organization.<sup>172</sup>

Certain rules prohibiting discrimination in favor of highly compensated employees, which apply to IRC section 403(b) plans generally, do not apply to a plan maintained by a church or qualified church-controlled organization.<sup>173</sup> For this purpose, church means a church, a convention or association of churches, or an elementary or secondary school that is controlled, operated, or principally supported by a church or by a convention or association of churches, and includes a qualified church-controlled organization. A qualified church-controlled organization is any church-controlled tax-exempt organization other than an organization that (1) offers goods, services, or facilities for sale, other than on an incidental basis, to the general public, other than goods, services, or facilities that are sold at a nominal charge substantially less than the cost of providing the goods, services, or facilities, and (2) normally receives more than 25 percent of its support from either governmental sources,

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<sup>170</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, page 35.

<sup>171</sup> IRC sections 403(b)(1)(A) and (7).

<sup>172</sup> IRC section 403(b)(9)(B), referring to organizations exempt from tax under IRC section 501(c)(3). For this purpose, a church or a convention or association of churches includes an organization described in IRC section 414(e)(3)(A), that is, an organization, the principal purpose or function of which is the administration or funding of a plan or program for the provision of retirement benefits or welfare benefits, or both, for the employees of a church or a convention or association of churches, provided that the organization is controlled by or associated with a church or a convention or association of churches.

<sup>173</sup> IRC sections 403(b)(1)(D) and (12).



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or receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities, in activities that are not unrelated trades or businesses, or from both. Church-controlled organizations that are not qualified church-controlled organizations are generally referred to as “nonqualified church-controlled organizations.”

In recent years, a question has arisen as to whether employees of nonqualified church- controlled organizations may be covered under an IRC section 403(b) plan that consists of a retirement income account.

New Federal Law (IRC section 403(b))

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>174</sup>

The proposal clarifies that a retirement income account may cover a duly ordained, commissioned, or licensed minister of a church in the exercise of his ministry, regardless of the source of his compensation; an employee of an organization, whether a civil law corporation or otherwise, that is exempt from tax under IRC section 501 and is controlled by or associated with a church or a convention or association of churches; and an employee who is included in a church plan under certain circumstances after separation from the service of a church, a convention or association of churches, or an organization described above.<sup>175</sup>

Effective Date

The proposal applies to years beginning before, on, or after December 20, 2019.

California Law (R&TC sections 17501 and 24601)

California’s PITL and CTL generally conform by reference to the federal rules under IRC section 403(b) as of the “specified date” of January 1, 2015.<sup>176,177</sup> However, the PITL and CTL additionally provide that federal changes to IRC section 403(b) apply without regard to taxable year to the same extent as applicable for federal income tax purposes.<sup>178</sup> In other words, the PITL and CTL automatically conform to federal changes made to IRC section 403(b). As a result, the federal clarification of

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<sup>174</sup> Joint Committee on Taxation, Description of the Chairman’s Amendment in the Nature of a Substitute to H.R. 1994, the “Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019,” JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, pp. 35-36.

<sup>175</sup> These individuals are described in IRC sections 414(e)(3)(B) and (E).

<sup>176</sup> R&TC sections 17501(a) and 24601(a) conform to Subchapter D of Chapter 1 of Subtitle A of the IRC (consisting of IRC sections 401 to 436), relating to deferred compensation, except as otherwise provided.

<sup>177</sup> R&TC sections 17024.5 and 23051.5.

<sup>178</sup> R&TC sections 17501(b) and 24601(b).

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retirement income account rules relating to church-controlled organizations applies under California law.

Impact on California Revenue

Baseline.

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<u>Section</u>	<u>Section Title</u>
112	Qualified Cash or Deferred Arrangements Must Allow Long-term Employees Working More Than 500 but Less Than 1,000 Hours per Year to Participate

Background

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>179</sup>

Qualified Retirement Plans

Qualified retirement plans are of two general types: defined benefit plans, under which benefits are determined under a plan formula and paid from general plan assets, rather than individual accounts; and defined contribution plans which include IRC section 401(k) plans, under which benefits are based on a separate account for each participant, to which are allocated contributions, earnings and losses.

An IRC section 401(k) plan legally is not a separate type of plan, but is a profit-sharing or stock bonus plan<sup>180</sup> that contains a qualified cash or deferred arrangement under which employees may make elective deferrals.<sup>181</sup> IRC

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<sup>179</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, pp. 37-43.

<sup>180</sup> Defined contribution plans include money purchase pension plans, profit-sharing plans, and stock bonus plans. Certain pre-ERISA money purchase plans and rural cooperative plans may also include a qualified cash or deferred arrangement. Except for certain grandfathered plans, a State or local governmental employer may not maintain an IRC section 401(k) plan.

<sup>181</sup> Elective deferrals are generally made on a pretax basis, excludable from the participant's gross income when contributed but includable with attributable earnings when distributed. However, under IRC section 402A, an IRC section 401(k) plan is permitted to include a qualified Roth contribution program that permits a participant to elect to have all or a portion of the participant's elective deferrals under the plan treated as designated Roth contributions. Designated Roth contributions are not excludable from the participant's gross income when contributed, but qualified distributions of designated Roth contributions and attributable earnings are excluded from gross income (even though the earnings are not previously taxed). A qualified distribution is a distribution made after the end of a specified period (generally five years after the participant's first designated Roth contribution) and that is (1) made on or after the date on which the participant attains age 59½, (2) made to a

section 401(k) plans may be designed so that elective deferrals are made only if the employee affirmatively elects them. Alternatively, an IRC section 401(k) plan may provide for automatic enrollment, under which elective deferrals are made at a specified rate (referred to as a default rate) when an employee becomes eligible to participate unless the employee affirmatively elects not to make contributions or to make contributions at a different rate.

Other special rules apply to such arrangements. The maximum annual amount of elective deferrals that can be made by an employee to an IRC section 401(k) plan for a year for 2019 is \$19,000 plus \$6,000 for employees age 50 or older (catch-up contribution amount) or, if less, the employee's compensation.<sup>182</sup> IRC section 401(k) plans may provide for matching contributions, which are made on account of elective deferrals,<sup>183</sup> and may provide for employer nonelective contributions.

### Participation Requirement

A qualified retirement plan generally can delay participation in the plan based on attainment of age or completion of years of service but not beyond the later of completion of one year of service (that is, a 12-month period with at least 1,000 hours of service) or attainment of age 21.<sup>184</sup> A plan also cannot exclude an employee from participation (on the basis of age) when that employee has attained a specified age.<sup>185</sup> Employees can be excluded from plan participation on other bases, such as job classification, as long as the other basis is not an indirect age or service requirement. A plan can provide that an employee is not entitled to an allocation of employer nonelective or matching contributions for a plan year unless the employee completes either 1,000 hours of service during the plan year or is employed on the last day of the year even if the employee previously completed 1,000 hours of service in a prior year. However, once an employee has completed 1,000 hours of service during a plan year, an employee cannot be precluded from making elective deferrals based on a service requirement.<sup>186</sup>

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beneficiary (or to the estate of the participant) on or after the death of the participant, or (3) attributable to the participant's being disabled.

<sup>182</sup> IRC sections 402(g) and 414(v).

<sup>183</sup> IRC section 401(m). Matching contributions can also be made on account of after-tax employee contributions.

<sup>184</sup> IRC sections 401(a)(3) and 410(a)(1). Parallel requirements generally apply to plans of private employers under IRC section 202 of the [ERISA]. Governmental plans under IRC section 414(d) and church plans under IRC section 414(e) are generally exempt from these IRC requirements and from ERISA.

<sup>185</sup> IRC section 410(a)(2).

<sup>186</sup> IRC section 401(k)(2)(D).

## Vesting

Qualified retirement plans are subject to requirements as to the period of service after which a participant's right to his or her accrued benefit must be nonforfeitable (that is, vested).<sup>187</sup> Generally, a year of vesting service is only required to be credited if an employee completes 1,000 hours of service during the year.

In the case of a defined contribution plan, a participant's accrued benefit is the balance of his or her account under the plan. The portion of an employee's account balance attributable to employee after-tax contributions and elective deferrals must be nonforfeitable at all times.<sup>188</sup>

Generally, the portion of an employee's account balance attributable to nonelective or matching contributions must become nonforfeitable after the completion of a specified number of years of service in accordance with one of two minimum vesting schedules.<sup>189</sup> Under the first vesting schedule, the participant's accrued benefit derived from employer contributions must become 100 percent vested upon completion of no more than three years of service (often referred to as three year cliff vesting). Under the second vesting schedule (referred to as graduated vesting), the participant's accrued benefit derived from employer contributions must become vested ratably at least over the period from two to six years of service.

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<sup>187</sup> IRC sections 401(a)(7) and 411. Governmental plans and church plans are generally exempt from these IRC requirements. Parallel requirements generally apply to plans of private employers under IRC sections 203-204 of ERISA.

<sup>188</sup> IRC sections 411(a)(1) and 401(k)(2)(C). Certain nonelective contributions under an IRC section 401(k) plan and employer matching contributions with respect to elective deferrals must also be nonforfeitable at all times.

<sup>189</sup> IRC section 411(a)(2)(B). IRC section 411(a)(3) provides certain permitted forfeitures for accrued benefits that are otherwise 100 percent vested, including, for example, forfeiture upon the participant's death or withdrawal of mandatory employee contributions and suspension of benefits upon reemployment.

## Minimum Coverage and Nondiscrimination Requirements

### *In General*

A qualified retirement plan is prohibited from discriminating in favor of highly compensated employees, referred to as the nondiscrimination requirements.

These requirements are intended to ensure that a qualified retirement plan provides meaningful benefits to an employer's rank-and-file employees as well as highly compensated employees, so that qualified retirement plans achieve the goal of retirement security for both lower-paid and higher-paid employees. The nondiscrimination requirements consist of a minimum coverage requirement and general nondiscrimination requirements.<sup>190</sup> For purposes of these requirements, an employee generally is treated as highly compensated if the employee (1) was a five-percent owner of the employer at any time during the year or the preceding year, or (2) had compensation for the preceding year in excess of \$125,000 (for 2019).<sup>191</sup>

The minimum coverage and general nondiscrimination requirements apply annually on the basis of the plan year. In applying these requirements, employees of all members of a controlled group or affiliated service group are treated as employed by a single employer. Employees who have not satisfied minimum age and service conditions under the plan, certain nonresident aliens, and employees covered by a collective bargaining agreement are generally disregarded.<sup>192</sup> However, a plan that covers employees with less than a year of service or who are under age 21 must generally include those employees in any nondiscrimination test for the year but can test the plan for nondiscrimination in two parts: (1) by separately testing the portion of the plan covering employees who have not completed a year of service or are under age 21 and treating all of the employer's employees with less than a year of service or under age 21 as the only employees of the employer; and (2) then testing the rest of the plan taking into account the rest of the employees of the employer and excluding those employees. If a plan does not satisfy the nondiscrimination requirements on its own, it may in some circumstances be

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<sup>190</sup> IRC sections 401(a)(3) and 410(b) deal with the minimum coverage requirement; IRC section 401(a)(4) deals with the general nondiscrimination requirements, with related rules in IRC section 401(a)(5). Detailed regulations implement the statutory requirements. Governmental plans are generally exempt from these requirements.

<sup>191</sup> IRC section 414(q). At the election of the employer, employees who are highly compensated based on compensation may be limited to the top 20 percent highest paid employees. A nonhighly compensated employee is an employee other than a highly compensated employee.

<sup>192</sup> A plan or portion of a plan covering collectively bargained employees is generally deemed to satisfy the nondiscrimination requirements.

aggregated with another plan, and the two plans tested together as a single plan.

#### *Minimum Coverage Requirement*

Under the minimum coverage requirement, the plan's coverage of employees must be nondiscriminatory. This is determined by calculating the plan's ratio percentage, that is, the ratio of the percentage of nonhighly compensated employees (of all nonhighly compensated employees in the workforce) covered under the plan over the percentage of highly compensated employees covered. In the case of an IRC section 401(k) plan, the right to make elective deferrals, the right to receive matching contributions, and the allocation of nonelective contributions are each tested separately for nondiscriminatory coverage as though provided under separate plans.

If the plan's ratio percentage is 70 percent or greater, the plan satisfies the minimum coverage requirement. If the plan's ratio percentage is less than 70 percent, a multi-part test applies. First, the plan must cover a group (or classification) of employees that is reasonable and established under objective business criteria, such as hourly or salaried employees (referred to as a reasonable classification), and the plan's ratio percentage must be at or above a specific level specified in the regulations. In addition, the average benefit percentage test must be satisfied. Under the average benefit percentage test, the average rate of contributions or benefit accruals for all nonhighly compensated employees in the workforce (taking into account all plans of the employer) must be at least 70 percent of the average contribution or accrual rate of all highly compensated employees.

#### General Nondiscrimination Requirements

##### *Nondiscrimination in the Amount of Contributions or Benefits*

There are two general approaches to testing the amount of contributions benefits under a qualified retirement plan:<sup>193</sup> (1) design-based safe harbors under which the benefit formula under a defined benefit plan, or the formula for allocating employer nonelective contributions under a defined contribution plan to participants' accounts, satisfies certain uniformity standards; and (2) a

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<sup>193</sup> Treas. Reg. section 1.401(a)(4)-1. With respect to the amount of contributions, employee elective deferrals under an IRC section 401(k) plan and employer matching contributions and after-tax employee contributions to a defined contribution plan are subject to special testing rules, rather than being included in applying the general nondiscrimination requirements. In addition, the amount of employer contributions to an ESOP is tested separately from other employer contributions. Rules applicable to benefits, rights and features and the timing of plan amendments are provided in Treas. Reg. sections 1.401(a)(4)-4 and -5 respectively.



mechanical general test under which the distribution of the rates of benefit among highly compensated and nonhighly compensated employees within a plan is tested for nondiscrimination by applying a modified version of the minimum coverage requirement.<sup>194</sup> The safe harbors and general test may include cross-testing of equivalent accruals or allocations.<sup>195</sup> A plan is not discriminatory merely because benefit accruals or allocations for highly compensated and nonhighly compensated employees are provided as a percentage of compensation (up to \$280,000 for 2019).<sup>196</sup> Thus, the various testing approaches are generally applied to the amount of contributions or benefits provided as a percentage of compensation (expressed as allocation or accrual rates).

#### *Special Nondiscrimination Tests for IRC Section 401(k) Plans*

A special annual nondiscrimination test, called the actual deferral percentage test (the ADP test) applies to test the amount of elective deferrals under an IRC section 401(k) plan.<sup>197</sup> The ADP test generally compares the average rate of deferral for highly compensated employees to the average rate of deferral for nonhighly compensated employees.

The ADP test allows the average deferral rate for highly compensated employees to exceed that for nonhighly compensated employees within limits: (1) the average deferral rate for highly compensated employees can be up to 125 percent of the average deferral rate for nonhighly compensated employees; or (2) the average deferral rate for highly compensated employees can be two percentage points greater than the average deferral rate for nonhighly compensated employees or, if less, twice the average deferral rate for nonhighly compensated employees. Employer matching contributions and after-tax employee contributions are subject to a similar special nondiscrimination test (the actual contribution percentage test or ACP test) which compares the average rate of matching and after-tax contributions to the plan of the two groups.<sup>198</sup>

If the ADP test is not satisfied, a mechanism is provided for the employer to make immediately vested additional contributions for nonhighly compensated employees (and certain other corrections) or to distribute deferrals of highly

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<sup>194</sup> These approaches are explained in Treas. Reg. sections 1.401(a)(4)-2 and -3 and -8. IRC sections 401(a)(5)(C)-(D) and 401(l) and Treas. Reg. sections 1.401(a)(4)-7 and 1.401(l)-1 through -6 provide rules under which nondiscrimination testing may take into account the employer-paid portion of social security taxes or benefits, referred to as permitted disparity.

<sup>195</sup> Treas. Reg. section 1.401(a)(4)-8.

<sup>196</sup> IRC section 401(a)(5)(B).

<sup>197</sup> IRC section 401(k)(3).

<sup>198</sup> IRC section 401(m)(2).



compensated employees to such employees, so that the ADP test is satisfied. Similar correction mechanisms apply for purposes of satisfying the ACP test.

There are also designed-based safe harbor methods of satisfying the ADP and ACP tests. These safe harbors are based on the premise that, for an IRC section 401(k) plan with certain design features with respect to contributions (elective, matching, and nonelective) and enrollment (one of the safe harbors is combined with automatic enrollment), satisfaction of the minimum coverage requirement is a sufficient test of the amount of whether the amount elective deferrals and matching contributions are nondiscriminatory.<sup>199</sup>

### Top Heavy Rules

Top-heavy rules apply to limit the extent to which accumulated benefits or account balances under a qualified retirement plan can be concentrated with key employees.<sup>200</sup> Whereas the general nondiscrimination requirements are designed to test annual contributions or benefits for highly compensated employees, compared to those of nonhighly compensated employees, the top-heavy rules test the portion of the total plan contributions or benefits that have accumulated for the benefit of key employees as a group. If a plan is top-heavy, minimum contributions or benefits are required for participants who are non-key employees, and, in some cases, faster vesting is required. Non-key employees who have become participants in a defined contribution plan, but who subsequently fail to complete 1,000 hours of service (or the equivalent) for an accrual computation period must receive the top-heavy defined contribution minimum.

For this purpose, a key employee is an officer with annual compensation greater than \$180,000 (for 2019), a five-percent owner, or a one-percent owner with compensation in excess of \$150,000. A defined benefit plan generally is top-heavy if the present value of cumulative accrued benefits for key employees exceeds 60 percent of the cumulative accrued benefits for all employees. A defined contribution plan is top-heavy if the aggregate of accounts for key employees exceeds 60 percent of the aggregate accounts for all employees.

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<sup>199</sup> The safe harbors that only require certain matching contributions potentially allow satisfaction of the nondiscrimination requirement with respect to elective and matching contributions under a 401(k) plan for a year even though no contributions are ultimately provided to nonhighly compensated employees under the plan for the year due to a lack of voluntary participation.

<sup>200</sup> IRC sections 401(a)(10)(B) and 416. The nature of the top-heavy test is such that a plan of a large business with many employees is unlikely to be top-heavy. The top-heavy requirements are therefore viewed as primarily affecting plans of smaller employers in which the owners participate.

## IRC Section 403(b) and Governmental IRC Section 457(b) Plans

Tax-deferred annuity plans (referred to as IRC section 403(b) plans) plans are generally similar to qualified defined contribution plans, but may be maintained only by (1) tax-exempt charitable organizations,<sup>201</sup> and (2) educational institutions of State or local governments (that is, public schools, including colleges and universities).<sup>202</sup> IRC section 403(b) plans may provide for employees to make elective deferrals (in pretax or designated Roth form), including catch-up contributions, or other after-tax employee contributions, and employers may make nonelective or matching contributions on behalf of employees. Contributions to an IRC section 403(b) plan are generally subject to the same contribution limits applicable to qualified defined contribution plans, including the limits on elective deferrals.

Contributions to an IRC section 403(b) plan must be fully vested. The minimum coverage and general nondiscrimination requirements applicable to a qualified retirement plan generally apply to an IRC section 403(b) plan and to employer matching and nonelective contributions and after-tax employee contributions to the plan.<sup>203</sup> If an IRC section 403(b) plan provides for elective deferrals, the plan is subject to a universal availability requirement under which all employees must be given the opportunity to make deferrals of more than \$200. In applying this requirement, nonresident aliens, students, and employees who normally work less than 20 hours per week may be excluded.<sup>204</sup>

An eligible deferred compensation plan of a governmental employer (referred to as a governmental IRC section 457(b) plan) is generally similar to a qualified cash-or deferred arrangement under an IRC section 401(k) plan in that it consists of elective deferrals, that is, contributions (in pretax or designated Roth form) made at the election of an employee, including catch-up contributions. Deferrals under a governmental IRC section 457(b) plan are generally subject to the same limits as elective deferrals under an IRC section 401(k) plan or an IRC section 403(b) plan.

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<sup>201</sup> These are organizations exempt from tax under IRC section 501(c)(3). IRC section 403(b) plans of private, tax- exempt employers may be subject to ERISA as well as the requirements of IRC section 403(b).

<sup>202</sup> IRC section 403(b).

<sup>203</sup> These requirements do not apply to a governmental IRC section 403(b) plan or an IRC section 403(b) plan maintained by a church or a qualified church-controlled organization as defined in IRC section 3121(w).

<sup>204</sup> For this purpose, nonresident has the meaning in IRC section 410(b)(3)(C), and student has the meaning in IRC section 3121(b)(10). The universal availability requirement does not apply to an IRC section 403(b) plan maintained by a church or a qualified church-controlled organization.

New Federal Law (IRC section 401(k))

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>205</sup>

The proposal requires an IRC section 401(k) plan to permit an employee to make elective deferrals if the employee has worked at least 500 hours per year with the employer for at least three consecutive years and has met the age requirement (age 21) by the end of the three consecutive year period (for this proposal, an employee is referred to as a long-term part-time employee after having completed this period of service). Thus, a long-term part-time employee could not be excluded from the plan because the employee has not completed a year of service as defined under the participation requirements described above (a 12-month period with at least 1,000 hours of service). Once a long-term part-time employee meets the age and service requirements, such employee must be able to commence participation no later than the earlier of (1) the first day of the first plan year beginning after the date on which the employee satisfied the age and service requirements or (2) the date 6 months after the date on which the individual satisfied those requirements.

Employers may, but are not required to, allow long-term part-time employees to participate in the design based safe harbors (including the automatic enrollment safe harbor). If an employer does permit a long-term part-time employee to participate in such an automatic enrollment 401(k) plan, that employee would have elective deferrals automatically made at the default rate unless the employee affirmatively elects not to make contributions or to make contributions at a different rate.

The proposal does not require a long-term part-time employee to be otherwise eligible to participate in the plan. Thus, the plan can continue to treat a long-term part-time employee as ineligible under the plan for employer nonelective and matching contributions based on not having completed a year of service. However, for a plan that does provide employer contributions for long-term part-time employees, the proposal requires a plan to credit, for each year in which such an employee worked at least 500 hours, a year of service for purposes of vesting in any employer contributions.

With respect to long-term part-time employees, employers would receive nondiscrimination testing relief (similar to the present-law rules for plans covering otherwise excludable employees), including permission to exclude these employees from top-heavy vesting and top-heavy benefit requirements.

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<sup>205</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, pp. 44-45.

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However, the relief from the nondiscrimination rules ceases to apply to any employee who becomes a full-time employee (as of the first plan year beginning after the plan year in which the employee completes a 12-month period with at least 1,000 hours of service).

This proposal does not apply to collectively bargained employees.

Effective Date

The provision applies to plan years beginning after December 31, 2020, except that for determining whether the three consecutive year period has been met, 12-month periods beginning before January 1, 2021, will not be taken into account.

California Law (R&TC sections 17501 and 24601)

California's PITL and CTL generally conform by reference to the federal rules under IRC section 401(k) as of the "specified date" of January 1, 2015.<sup>206,207</sup> However, the PITL and CTL additionally provide that federal changes to IRC section 401(k) apply without regard to taxable year to the same extent as applicable for federal income tax purposes.<sup>208</sup> In other words, the PITL and CTL automatically conform to federal changes made to IRC section 401(k). As a result, the federal requirement that qualified cash or deferred arrangements must allow long-term employees working more than 500 but less than 1,000 hours per year to participate automatically applies under California law.

Impact on California Revenue

Baseline.

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<u>Section</u>	<u>Section Title</u>
113	Penalty-free Withdrawals from Retirement Plans for Individuals in Case of Birth of Child or Adoption

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<sup>206</sup> R&TC sections 17501(a) and 24601(a) conform to Subchapter D of Chapter 1 of Subtitle A of the IRC (consisting of IRC sections 401 to 436), relating to deferred compensation, except as otherwise provided.

<sup>207</sup> R&TC sections 17024.5 and 23051.5.

<sup>208</sup> R&TC sections 17501(b) and 24601(b).

## Background

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>209</sup>

### Distributions from Tax-Favored Retirement Plans

A distribution from a qualified retirement plan, a tax-sheltered annuity plan (an IRC section 403(b) plan), an eligible deferred compensation plan of a State or local government employer (a governmental IRC section 457(b) plan), or an IRA generally is included in income for the year distributed.<sup>210</sup> These plans are referred to collectively as eligible retirement plans. In addition, unless an exception applies, a distribution from a qualified retirement plan, an IRC section 403(b) plan, or an IRA received before age 59½ is subject to a 10-percent additional tax (referred to as the early withdrawal tax) on the amount includible in income.<sup>211</sup>

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

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

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<sup>209</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, page 45.

<sup>210</sup> IRC sections 401(a), 403(a), 403(b), 457(b) and 408. Under IRC section 3405, distributions from these plans are generally subject to income tax withholding unless the recipient elects otherwise. In addition, certain distributions from a qualified retirement plan, an IRC section 403(b) plan, or a governmental IRC section 457(b) plan are subject to mandatory income tax withholding at a 20-percent rate unless the distribution is rolled over.

<sup>211</sup> IRC section 72(t). Under present law, the 10-percent early withdrawal tax does not apply to distributions from a governmental IRC section 457(b) plan.

New Federal Law (IRC section 72(t))

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>212</sup>

In General

Under the proposal, an exception to the 10-percent early withdrawal tax applies in the case of a qualified birth or adoption distribution from an applicable eligible retirement plan (as defined). In addition, qualified birth or adoption distributions may be recontributed to an individual's applicable eligible retirement plans, subject to certain requirements.

Distributions from Applicable Eligible Retirement Plans

A qualified birth or adoption distribution is a permissible distribution from an applicable eligible retirement plan which, for this purpose, encompasses eligible retirement plans other than defined benefit plans, including qualified retirement plans, IRC section 403(b) plans, governmental IRC section 457(b) plans, and IRAs.<sup>213</sup>

A qualified birth or adoption distribution is a distribution from an applicable eligible retirement plan to an individual if made during the one-year period beginning on the date on which a child of the individual is born or on which the legal adoption by the individual of an eligible adoptee is finalized. An eligible adoptee means any individual (other than a child of the taxpayer's spouse) who has not attained age 18 or is physically or mentally incapable of self-support. The proposal requires the name, age, and taxpayer identification number of the child or eligible adoptee to which any qualified birth or adoption distribution relates to be provided on the tax return of the individual taxpayer for the taxable year.

The maximum aggregate amount which may be treated as qualified birth or adoption distributions by any individual with respect to a birth or adoption is \$5,000. The maximum aggregate amount applies on an individual basis. Therefore, each spouse separately may receive a maximum aggregate amount of \$5,000 of qualified birth or adoption distributions (with respect to a birth or adoption) from applicable eligible retirement plans in which each spouse participates or holds accounts.

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<sup>212</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, pp. 45-47.

<sup>213</sup> A qualified birth or adoption distribution is subject to income tax withholding unless the recipient elects otherwise. Mandatory 20-percent withholding does not apply.

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An employer plan is not treated as violating any IRC requirement merely because it treats a distribution (that would otherwise be a qualified birth or adoption distribution) to an individual as a qualified birth or adoption distribution, provided that the aggregate amount of such distributions to that individual from plans maintained by the employer and members of the employer's controlled group<sup>214</sup> does not exceed \$5,000. Thus, under such circumstances an employer plan is not treated as violating any IRC requirement merely because an individual might receive total distributions in excess of \$5,000 as a result of distributions from plans of other employers or IRAs.

#### Recontributions to Applicable Eligible Retirement Plans

Generally, any portion of a qualified birth or adoption distribution may, at any time after the date on which the distribution was received, be recontributed to an applicable eligible retirement plan to which a rollover can be made. Such a recontribution is treated as a rollover and thus is not includible in income. If an employer adds the ability for plan participants to receive qualified birth or adoption distributions from a plan, the plan must permit an employee who has received qualified birth or adoption distributions from that plan to recontribute only up to the amount that was distributed from that plan to that employee, provided the employee otherwise is eligible to make contributions (other than recontributions of qualified birth or adoption distributions) to that plan. Any portion of a qualified birth or adoption distribution from an individual's applicable eligible retirement plans (whether employer plans or IRAs) may be recontributed to an IRA held by such an individual which is an applicable eligible retirement plan to which a rollover can be made.

#### Effective Date

The provision applies to distributions made after December 31, 2019.

#### California Law (R&TC sections 17081 and 17085)

California's PITL generally conforms by reference to the federal rules under IRC section 72 as of the "specified date" of January 1, 2015.<sup>215,216</sup>

California also automatically conforms to federal changes made to the additional tax on early distributions from qualified retirement plans, modified to provide that the

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<sup>214</sup> The term "controlled group" means any group treated as a single employer under subsection (b), (c), (m), or (o) of IRC section 414.

<sup>215</sup> R&TC section 17081 conforms to Subchapter B of Chapter 1 of Subtitle A of the IRC (consisting of IRC sections 71 to 91), relating to items specifically included in gross income, except as otherwise provided.

<sup>216</sup> R&TC section 17024.5.

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California early-distribution tax is 2.5 percent of the amount includible in income rather than the federal rate of 10 percent.<sup>217</sup> As a result, California conforms to the federal provision allowing penalty-free withdrawals from retirement plans for individuals in the case of the birth of a child or an adoption.

Impact on California Revenue

Baseline.

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<u>Section</u>	<u>Section Title</u>
114	Increase in Age for Required Beginning Date for Mandatory Distributions

Background

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>218</sup>

Required Minimum Distributions

Employer-provided qualified retirement plans, traditional IRAs, and individual retirement annuities are subject to required minimum distribution rules. A qualified retirement plan for this purpose means a tax-qualified plan described in IRC section 401(a) (such as a defined benefit pension plan or an IRC section 401(k) plan), employee retirement annuities described in IRC section 403(a), tax-sheltered annuities described in IRC section 403(b), and a plan described in IRC section 457(b) that is maintained by a governmental employer.<sup>219</sup> An employer-provided qualified retirement plan that is a defined contribution plan is a plan which provides (1) an individual account for each participant and (2) for benefits based on the amount contributed to the participant's account, and any income, expenses, gains, losses, and forfeitures of accounts of other participants which may be allocated to such participant's account.<sup>220</sup>

Required minimum distributions generally must begin by April 1 of the calendar year following the calendar year in which the individual (employee or IRA owner) reaches age 70½. However, in the case of an employer-provided qualified retirement plan, the required minimum distribution date for an individual who is not a 5-percent owner of the employer maintaining the plan

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<sup>217</sup> R&TC section 17085(c).

<sup>218</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, pp. 48-50.

<sup>219</sup> The required minimum distribution rules also apply to IRC section 457(b) plans maintained by tax-exempt employers other than governmental employers.

<sup>220</sup> IRC section 414(i).

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may be delayed to April 1 of the year following the year in which the individual retires if the plan provides for this later distribution date. For all subsequent years, including the year in which the individual was paid the first required minimum distribution by April 1, the individual must take the required minimum distribution by December 31 of the year.

For IRAs and defined contributions plans, the required minimum distribution for each year generally is determined by dividing the account balance as of the end of the prior year by a distribution period,<sup>221</sup> generally a number in the uniform lifetime table.<sup>222</sup> This table is based on joint life expectancies of the individual and a hypothetical beneficiary 10 years younger than the individual. For an individual with a spouse as designated beneficiary who is more than 10 years younger (and thus the number of years in the couple's joint life expectancy is greater than the uniform life time table), the joint life expectancy of the couple is used. There are special rules in the case of annuity payments from an insurance contract.

If an individual dies on or after the individual's required beginning date, the required minimum distribution is also determined by dividing the account balance as of the end of the prior year by a distribution period. The distribution period is equal to the remaining years of the beneficiary's life expectancy or, if there is no designated beneficiary, a distribution period equal to the remaining years of the deceased individual's single life expectancy, using the age of the deceased individual in the year of death.<sup>223</sup>

In the case of an individual who dies before the individual's required beginning date, there are two methods for satisfying the after death required minimum distribution rules, the life expectancy rule or the five year rule. Under the life expectancy rule, annual required minimum distributions must begin no later than December 31 of the calendar year immediately following the calendar year in which the individual died. This rule is only available if the designated beneficiary is an individual (e.g., not the individual's estate or a charity). If the designated beneficiary is the individual's spouse, commencement of distributions can be delayed until December 31 of the calendar year in which the deceased individual would have attained age 70½. The required minimum distribution for each year is also determined by dividing the account balance as of the end of the prior year by a distribution period, which is determined by reference to the beneficiary's life expectancy.<sup>224</sup> Under the five-year rule, the

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<sup>221</sup> Treas. Reg. section 1.401(a)(9)-5.

<sup>222</sup> Treas. Reg. section 1.401(a)(9)-9.

<sup>223</sup> Treas. Reg. section 1.401(a)(9)-5, A-5(a).

<sup>224</sup> Treas. Reg. section 1.401(a)(9)-5, A-5(b).

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individual's entire account must be distributed no later than December 31 of the calendar year containing the fifth anniversary of the individual's death.<sup>225</sup>

A special after-death rule applies for an IRA if the beneficiary of the IRA is the surviving spouse. The surviving spouse is permitted to choose to calculate required minimum distributions while the spouse is alive, and after the spouse's death, as though the spouse is the IRA owner, rather than a beneficiary.

Roth IRAs are not subject to the minimum distribution rules during the IRA owner's lifetime. However, Roth IRAs are subject to the post-death minimum distribution rules that apply to traditional IRAs. For Roth IRAs, the IRA owner is treated as having died before the individual's required beginning date. Thus only the life expectancy rule and the five year rule apply.

Failure to make a required minimum distribution triggers a 50-percent excise tax, payable by the individual or the individual's beneficiary. The tax is imposed during the taxable year that begins with or within the calendar year during which the distribution was required.<sup>226</sup> The tax may be waived if the distribution did not occur because of reasonable error and reasonable steps are taken to remedy the violation.<sup>227</sup>

### Eligible Rollover Distributions

With certain exceptions, distributions from an employer-provided qualified retirement plan are eligible to be rolled over tax free into another employer-provided qualified retirement plan or an IRA. This can be achieved by contributing the amount of the distribution to the other plan or IRA within 60 days of the distribution, or by a direct payment by the plan to the other plan or IRA (referred to as a direct rollover). Distributions that are not eligible for rollover include (i) any distribution that is one of a series of periodic payments generally for a period of 10 years or more (or, if a shorter period, certain life expectancies) and (ii) any distribution to the extent that the distribution is a required minimum distribution.<sup>228</sup>

For any distribution that is eligible for rollover, an employer-provided tax-qualified retirement plan must offer the distributee the right to have the distribution made in a direct rollover<sup>229</sup> and, before making the distribution, the

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<sup>225</sup> Treas. Reg. section 1.401(a)(9)-3, Q&As 1, 2.

<sup>226</sup> IRC section 4974(a).

<sup>227</sup> IRC section 4974(d).

<sup>228</sup> IRC section 402(c)(4). Distributions that are not eligible rollover distributions also include distributions made upon hardship of the employee and any qualified disaster relief distribution (within the meaning of IRC section 72(t)(2)(G)).

<sup>229</sup> IRC section 401(a)(31).

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plan administrator must provide the distributee with a written explanation of the direct rollover right and related tax consequences.<sup>230</sup> If a distributee does not choose to have the distribution made in a direct rollover, the distribution is generally subject to mandatory 20-percent income tax withholding.<sup>231</sup>

New Federal Law (IRC section 401(a))

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>232</sup>

The proposal changes the age on which the required beginning date for required minimum distributions is based, from the calendar year in which the employee or IRA owner attains 70½ years to the calendar year in which the employee or IRA owner attains 72 years. Under the proposal, present law continues to apply to employees and IRA owners who attain age 70½ prior to January 1, 2020.

In addition, the present law requirement to actuarially adjust an employee's accrued benefit for an employee who retires in a calendar year after the year the employee attains age 70½ to take into account the period after age 70½ in which the employee was not receiving any benefits under the plan, is not changed.

Effective Date

The provision is effective for distributions required to be made after December 31, 2019, for employees and IRA owners who attain age 70½ after December 31, 2019.

California Law (R&TC sections 17501 and 24601)

California's PITL and CTL generally conform by reference to the federal rules under IRC section 401(a) as of the "specified date" of January 1, 2015.<sup>233,234</sup> However, the PITL and CTL additionally provide that federal changes to IRC section 401(a) apply without regard to taxable year to the same extent as applicable for federal income tax purposes.<sup>235</sup> In other words, the PITL and CTL automatically conform to federal

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<sup>230</sup> IRC section 402(f).

<sup>231</sup> IRC section 3405(c). This mandatory withholding does not apply to a distributee that is a beneficiary other than a surviving spouse of an employee.

<sup>232</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, page 50.

<sup>233</sup> R&TC sections 17501(a) and 24601(a) conform to Subchapter D of Chapter 1 of Subtitle A of the IRC (consisting of IRC sections 401 to 436), relating to deferred compensation, except as otherwise provided.

<sup>234</sup> R&TC sections 17024.5 and 23051.5.

<sup>235</sup> R&TC sections 17501(b) and 24601(b).

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changes made to IRC section 401(a). As a result, the federal increase in age of the required beginning date for mandatory distributions automatically applies under California law.

Impact on California Revenue

Baseline.

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<u>Section</u>	<u>Section Title</u>
115	Special Rules for Minimum Funding Standards for Community Newspaper Plans

Background

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>236</sup>

The IRC and the [ERISA] apply minimum funding requirements<sup>237</sup> to defined benefit retirement plans maintained by private-sector employers for their employees (referred to as single-employer plans), for purposes of which employers that are members of a controlled group are considered a single employer.

Under these rules, a minimum contribution is required for a plan year if the value of the plan's assets is less than the plan's funding target, that is, the present value, determined actuarially, of all benefits earned as of the beginning of the year. If the value of plan assets is less than the plan's funding target, such that the plan has a funding shortfall, the shortfall is generally required to be funded by contributions, with interest, over seven years, taking into account the remaining installments attributable to shortfalls from preceding years.

In addition, if participants earn additional benefits for the year,<sup>238</sup> the required contribution must include the amount of the plan's target normal cost, that is,

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<sup>236</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, pp. 51-53.

<sup>237</sup> Special funding rules may apply to certain categories of single-employer plans. For example, special rules apply to certain plans maintained by commercial passenger airlines, under section 402 of the Pension Protection Act of 2006 (PPA), P.L. No. 109-280. If an election is made by a commercial passenger airline described in section 402(a)(1) of PPA, then in determining the plan's minimum required contribution under IRC section 430, the airline may use an interest rate of 8.85% to amortize the unfunded liability of the plan in equal installments over the remaining part of the 17-year amortization period. See Treas. Reg. section 1.430(a)-1(b)(4)(ii).

<sup>238</sup> In some cases, a plan may be frozen as to service and/or compensation. When a plan is frozen



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the present value, determined actuarially, of benefits expected to be earned for the year. In the case of a plan funded below a certain level, referred to as an at-risk plan, specified assumptions must be used in determining the plan's funding target and target normal cost.<sup>239</sup>

The minimum funding rules enacted in the Pension Protection Act of 2006 (PPA)<sup>240</sup> specify the interest rates used to determine a plan's funding target and target normal cost for a year, consisting of three segment rates, each of which applies to benefit payments expected to be made from the plan during a certain period.<sup>241</sup> The first segment rate applies to benefits reasonably determined to be payable during the five-year period beginning on the first day of the year; the second segment rate applies to benefits reasonably determined to be payable during the 15-year period following the initial

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with respect to both service and compensation, participants are entitled to previously earned benefits but do not accrue or earn additional benefits.

<sup>239</sup> For an at-risk plan, the specified assumptions generally are as follows: All employees who are not otherwise assumed to retire as of the valuation date but who will be eligible to elect benefits during the plan year and the next 10 plan years must be assumed to retire at the earliest retirement date under the plan but not before the end of the plan year for which the at-risk funding target and at-risk normal cost are being determined. Also, all employees must be assumed to elect the retirement benefit available under the plan at the assumed retirement age (determined as above) that would result in the highest present value of benefits. The at-risk funding target is the present value of all benefits accrued or earned under the plan as of the beginning of the plan year using the actuarial assumptions set forth in the IRC and regulations for single-employer plans, with the addition of a loading factor which arises when the plan has been in at-risk status for at least two of the four preceding plan years. This loading factor is equal to the sum of (1) \$700 multiplied by the number of participants in the plan and (2) four percent of the funding target (determined without regard to the definition of at-risk funding target). The at-risk normal cost for a plan year generally represents the excess of the sum of (1) the present value of all benefits which are expected to accrue or to be earned under the plan during the plan year using the at-risk assumptions described above plus (2) the amount of plan related expenses expected to be paid from plan assets during the plan year, over (3) the amount of mandatory employee contributions expected to be made during the plan year. In addition, where the plan has been in at-risk status for at least two of the four preceding plan years, a loading factor is added, which is equal to four percent of the target normal cost (the excess of the sum of (1) the present value of all benefits which are expected to accrue or to be earned under the plan during the plan year plus (2) the amount of plan-related expenses expected to be aid from plan assets during the plan year, over (3) the amount of mandatory employee contributions expected to be made during the plan year with respect to the plan for the plan year.

<sup>240</sup> P.L. No. 109-280.

<sup>241</sup> Each segment rate is a single interest rate determined monthly by the [Secretary], on the basis of a corporate bond yield curve, taking into account only the portion of the yield curve based on corporate bonds maturing during the particular segment rate period. The corporate bond yield curve used for this purpose reflects the average, for the 24-month period ending with the preceding month, of yields on investment grade corporate bonds with varying maturities and that are in the top three quality levels available. Solely for purposes of determining minimum required contributions, in lieu of the segment rates, an employer may elect to use interest rates on a yield curve based on the yields on investment grade corporate bonds for the month preceding the month in which the plan year begins (that is, without regard to the 24-month averaging described above) (monthly yield curve). If an election to use a monthly yield curve is made, it cannot be revoked without IRS approval.



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five-year period; and the third segment rate applies to benefits reasonably determined to be payable at the end of the 15-year period. The first, second, and third segment rates are based on the corresponding portion of a corporate bond yield curve with certain adjustments.

Under the Moving Ahead for Progress in the 21st Century Act,<sup>242</sup> for plan years beginning after December 31, 2011, a segment rate determined under the PPA rules is adjusted if it falls outside a specified percentage range of the average segment rates for a preceding period. In particular, if a segment rate determined under the PPA rules is less than the applicable minimum percentage in the specified range, the segment rate is adjusted upward to match the minimum percentage. If a segment rate determined under the PPA rules is more than the applicable maximum percentage in the specified range, the segment rate is adjusted downward to match the maximum percentage.

The specified percentage range (that is, the range from the applicable minimum percentage to the applicable maximum percentage of average segment rates), as most recently modified in the Bipartisan Budget Act of 2015,<sup>243</sup> for determining whether a segment rate must be adjusted upward or downward for a plan year is determined by reference to the calendar year in which the plan year begins as follows:

- 90 percent to 110 percent for 2012 through 2020,
- 85 percent to 115 percent for 2021,
- 80 percent to 120 percent for 2022,
- 75 percent to 125 percent for 2023, and
- 70 percent to 130 percent for 2024 or later.

For February 2019, the first, second, and third segment rates after adjustment are 3.01 percent, 4.11 percent, and 4.41 percent, respectively.<sup>244</sup>

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<sup>242</sup> P.L. No. 112-141. The Highway Transportation and Funding Act of 2014 (P.L. No. 113-159) made changes to the applicable minimum and maximum percentage ranges for determining whether a segment rate must be adjusted upward or downward, as well as the periods for determining such segment rates.

<sup>243</sup> P.L. No. 114-74.

<sup>244</sup> Notice 2019-21, 2019-14 I.R.B. These rates are determined and published monthly by the [IRS] by notice and on its website. See <https://www.irs.gov/retirement-plans/minimum-present-value-segment-rates>.

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New Federal Law (IRC section 430)

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>245</sup>

Under the proposal, an employer maintaining a community newspaper plan (as defined below) under which no participant has had the participant's accrued benefit increased (whether because of service or compensation) after December 31, 2017, may elect to apply certain alternative funding rules to the plan and any other plan sponsored by any member of the controlled group (determined as of the date of enactment).<sup>246</sup> An election under the proposal to apply the alternative funding rules is to be made at such time and in such manner as prescribed by the [Secretary], and once made with respect to a plan year, applies to all subsequent years unless revoked with the consent of the [Secretary].

Under the alternative funding rules, an interest rate of eight percent is used to determine a plan's funding target and target normal cost, rather than the first, second, and third segment rates. However, if new benefits are accrued or earned under a plan for a plan year in which the election is in effect, the present value of such benefits must be determined on the basis of the U.S. Treasury obligation yield curve for the day that is the valuation date of such plan for such plan year. In addition, if the value of plan assets is less than the plan's funding target, such that the plan has a funding shortfall, the shortfall is required to be funded by contributions, with interest, over 30 years, rather than over seven years. The shortfall amortization bases determined<sup>247</sup> for all plan years preceding the first plan year to which the election applies (and all related shortfall amortization installments) are reduced to zero. Further, the assumptions applicable to an at-risk plan do not apply.

Under the proposal, a community newspaper plan is a plan to which the new proposal applies, which is maintained by an employer that, as of December 31, 2017:

- Publishes and distributes daily, either electronically or in printed form, one or more community newspapers (as defined below) in a single State,
- Is not a company the stock of which is publicly traded on a stock exchange or in an over-the-counter market, and is not controlled,

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<sup>245</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, pp. 53-54.

<sup>246</sup> For this purpose, the controlled group means all persons treated as a single employer under subsection (b), (c), (m), or (o) of IRC section 414 as of the date of enactment.

<sup>247</sup> Under IRC section 430(c)(3).

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directly or indirectly, by such a company,

- Is controlled, directly or indirectly (a) by one or more persons residing primarily in the State in which the community newspaper is published; (b) for at least 30 years by individuals who are members of the same family; (c) by a trust created or organized in the State in which the community newspaper is published, the sole trustees of which are persons described in (a) or (b); (d) by an entity described in IRC section 501(c)(3) and exempt from tax under IRC section 501(a) that is organized and operated in the State in which the community newspaper is published, and the primary purpose of which is to benefit communities in the State; or (e) by a combination of persons described in (a), (c), or (d), and
- Does not control, directly or indirectly, any newspaper in any other State.

A community newspaper means a newspaper that primarily serves a metropolitan statistical area, as determined by the Office of Management and Budget, with a population of not less than 100,000. For purposes of the proposal, a person (the first person) is treated as controlled by another person if the other person possesses, directly or indirectly, the power to direct or cause the direction and management of the first person (including the power to elect a majority of the members of the board of directors of the first person) through the ownership of voting securities.

The proposal makes the above-described amendments to both the IRC and ERISA.<sup>248</sup>

### Effective Date

The provision applies the amendments to plan years ending after December 31, 2017.

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<sup>248</sup> The proposal adds a new subsection (m) to IRC section 430, and a new subsection (m) to section 303 of ERISA. However, the term community newspaper plan for ERISA purposes includes one that publishes and distributes daily, either electronically or in printed form, either a community newspaper or one or more community newspapers in the same State. Additionally, in the case of a community newspaper plan to which the election has been made, the proposal does not change the basis for calculating underfunding for purposes of Pension Benefit Guaranty Corporation variable rate premiums.

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California Law (R&TC sections 17501 and 24601)

California's PITL and CTL generally conform by reference to the federal rules under IRC section 430 as of the "specified date" of January 1, 2015.<sup>249,250</sup> However, the PITL and CTL additionally provide that federal changes to IRC section 430 apply without regard to taxable year to the same extent as applicable for federal income tax purposes.<sup>251</sup> In other words, the PITL and CTL automatically conform to federal changes made to IRC section 430. As a result, the federal special rules for minimum funding standards for community newspaper plans automatically apply under California law.

Impact on California Revenue

Baseline.

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<u>Section</u>	<u>Section Title</u>
116	Treating Excluded Difficulty of Care Payments as Compensation for Determining Retirement Contribution Limitations

Background

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>252</sup>

Difficulty of Care Payments

Gross income does not include amounts received by a foster care provider during the taxable year as qualified foster care payments.<sup>253</sup> Qualified foster care payments include any payment made pursuant to a foster care program of a State or political subdivision which is paid by (1) a State or political subdivision thereof or (2) a qualified foster care placement agency, and which is either (1) paid to the foster care provider for caring for a qualified foster individual in the foster care provider's home, or (2) a difficulty of care payment.<sup>254</sup> A qualified foster individual is any individual who is living in a foster family home in which the individual was placed by either an agency of a State

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<sup>249</sup> R&TC sections 17501(a) and 24601(a) conform to Subchapter D of Chapter 1 of Subtitle A of the IRC (consisting of IRC sections 401 to 436), relating to deferred compensation, except as otherwise provided.

<sup>250</sup> R&TC sections 17024.5 and 23051.5.

<sup>251</sup> R&TC sections 17501(b) and 24601(b).

<sup>252</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, pp. 55-56.

<sup>253</sup> IRC section 131(a).

<sup>254</sup> IRC section 131(b)(1).

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(or a political subdivision thereof) or a qualified foster care placement agency.<sup>255</sup> A qualified foster care placement agency is any placement agency which is licensed or certified by a State (or political subdivision thereof) or an entity designated by a State (or political subdivision thereof).<sup>256</sup>

A difficulty of care payment is compensation for providing the additional care needed for certain qualified foster individuals. Such payments are provided when a qualified foster individual has a physical, mental or emotional disability for which the state has determined that (1) there is a need for additional compensation to care for the individual, (2) the care is provided in the home of the foster care provider, and (3) the payments are designated by the payor as compensation for such purpose.<sup>257</sup> An applicant must request an assessment of need from the State agency administering the program and submit a medical evaluation which is reassessed every year.

In the case of a tax-qualified defined contribution plan, such a plan will not satisfy the tax qualification requirements unless contributions made by a participant to the plan (as well as other additions such as employer contributions and forfeitures) do not exceed the lesser of (1) \$40,000 or (2) 100 percent of the participant's compensation.<sup>258</sup> A participant's compensation is defined generally as the compensation of the participant from the employer for the year.<sup>259</sup> A special rule applies for self-employed individuals providing that a participant's compensation is the participant's earned income.<sup>260</sup> Similar rules apply for contributions made to an IRA.<sup>261</sup>

Since difficulty of care payments are excluded from gross income, home healthcare workers receiving only such payments are unable to participate in tax-qualified retirement plans or individual retirement accounts because difficulty of care payments are not considered compensation or earnings upon which contributions to such plans or accounts may be made.

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<sup>255</sup> IRC section 131(b)(2).

<sup>256</sup> IRC section 131(b)(3).

<sup>257</sup> Pursuant to IRC section 131(c)(2), in the case of any foster home, difficulty of care payments for any period to which such payments relate are not excludable from gross income to the extent such payments are made for more than 10 qualified foster individuals who have not attained age 19 and five qualified foster individuals who have attained age 19.

<sup>258</sup> IRC section 415(c)(1).

<sup>259</sup> IRC section 415(c)(3)(A).

<sup>260</sup> IRC section 415(c)(3)(B).

<sup>261</sup> See IRC sections 219, 408 and 408A.

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New Federal Law (IRC sections 408 and 415)

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>262</sup>

The proposal amends sections 415(c)(3) and 408(o) to increase the contribution limit to qualified retirement plans and individual retirement accounts to include “difficulty of care” payments.

Effective Dates

The provision applies to contributions to IRAs made after December 20, 2019, and to defined contribution plans for plan years beginning after December 31, 2015.

California Law (R&TC sections 17501 and 24601)

California’s PITL and CTL generally conform by reference to the federal rules under IRC sections 408 and 415 as of the “specified date” of January 1, 2015.<sup>263,264</sup> However, the PITL and CTL additionally provide that federal changes to IRC sections 408 and 415 apply without regard to taxable year to the same extent as applicable for federal income tax purposes.<sup>265</sup> In other words, the PITL and CTL automatically conform to federal changes made to IRC sections 408 and 415. As a result, the federal amendments treating excluded difficulty of care payments as compensation for determining retirement contribution limitations automatically apply under California law.

Impact on California Revenue

Baseline.

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<sup>262</sup> Joint Committee on Taxation, Description of the Chairman’s Amendment in the Nature of a Substitute to H.R. 1994, the “Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019,” JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, page 56.

<sup>263</sup> R&TC sections 17501(a) and 24601(a) conform to Subchapter D of Chapter 1 of Subtitle A of the IRC (consisting of IRC sections 401 to 436), relating to deferred compensation, except as otherwise provided.

<sup>264</sup> R&TC sections 17024.5 and 23051.5.

<sup>265</sup> R&TC sections 17501(b) and 24601(b).

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Title II —Administrative Improvements

<u>Section</u>	<u>Section Title</u>
201	Plan Adopted by Filing Due Date for Year May be Treated as in Effect of Close of Year

Background

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>266</sup>

In order for a qualified retirement plan to be treated as maintained for a taxable year, the plan must be adopted by the last day of the taxable year.<sup>267</sup> However, the trust under the plan will not fail to be treated as in existence due to lack of corpus merely because it holds no assets on the last day of the taxable year.<sup>268</sup> Contributions made by the due date (plus extensions) of the tax return for the employer maintaining the plan for a taxable year are treated as contributed on account of that taxable year.<sup>269</sup> Thus a plan can be established on the last day of a taxable year even though the first contribution is not made until the due date of the employer's return of tax for the taxable year. Further, if the terms of a plan adopted during an employer's taxable year fail to satisfy the qualification requirements that apply to the plan for the year, the plan may also be amended retroactively by the due date (including extensions) of the employer's return, provided that the amendment is made retroactively effective.<sup>270</sup> However, this provision does not allow a plan to be adopted after the end of a taxable year and made retroactively effective, for qualification purposes, for the taxable year prior to the taxable year in which the plan was adopted by the employer.<sup>271</sup>

New Federal Law (IRC section 401(b))

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>272</sup>

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<sup>266</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, page 57.

<sup>267</sup> Rev. Rul. 76-28, 1976-1 C.B. 106.

<sup>268</sup> Rev. Rul. 81-114, 1981-1 C.B. 207.

<sup>269</sup> IRC section 404(a)(6).

<sup>270</sup> IRC section 401(b).

<sup>271</sup> Treas. Reg. section 1.401(b)-1(a). Also for the entire discussion, refer to the Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, p. 57.

<sup>272</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, pp. 57.



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Under the proposal, if an employer adopts a qualified retirement plan after the close of a taxable year, but before the extended due date of the return, the employer can elect to treat the plan as having been adopted as of the last day of the taxable year.

The proposal does not override rules requiring certain plan provisions to be in effect during a plan year, such as the provision for elective deferrals under a qualified cash or deferral arrangement (“generally referred to as a 401(k) plan”).<sup>273</sup>

Effective Date

The provision applies to plans adopted for taxable years beginning after December 31, 2019.

California Law (R&TC sections 17501 and 24601)

California’s PITL and CTL generally conform by reference to the federal rules related to qualified retirement plans under IRC section 401(b) as of the “specified date” of January 1, 2015. However, both the PITL and CTL additionally provide that federal changes to IRC section 401(b) apply without regard to taxable year to the same extent as applicable for federal income tax purposes. In other words, both the PITL and CTL automatically conform to federal changes made to IRC section 401(b). As a result, the plan adoption rule automatically applies under California law.

Impact on California Revenue

Baseline.

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<u>Section</u>	<u>Section Title</u>
202	Combined Annual Report for Group of Plans

Background

A federal Form 5500, Annual Return/Report of Employee Benefit Plan, is required to be filed annually with the DOL by an employer maintaining a qualified retirement plan.<sup>274</sup> In addition, the plan administrator of certain pension and welfare benefit

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<sup>273</sup> Treas. Reg. section 1.401(k)-1(e)(2)(ii). Also for the entire discussion, refer to the Joint Committee on Taxation, Description of the Chairman’s Amendment in the Nature of a Substitute to H.R. 1994, the “Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019,” JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, p. 57.

<sup>274</sup> IRC section 6058. In addition, under IRC section 6059, the plan administrator of a defined benefit plan subject to the minimum funding requirements is required to file an annual actuarial report. Under

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plans is also required to file the federal Form 5500 with the DOL.<sup>275</sup> A separate Form 5500 is required for each plan;<sup>276</sup> and the DOL shares this information with the IRS.<sup>277</sup>

New Federal Law (IRC sections 414(i) and 6058)

The provision directs the IRS and DOL to modify the federal Form 5500 so all members of a group of plans may file a single consolidated Form 5500. The modified consolidated Form 5500 may require information for each plan within the consolidated group, as is determined to be necessary or appropriate for the enforcement and administration of the IRC and ERISA.<sup>278</sup>

For purposes of the provision, a group of plans is eligible for a consolidated federal Form 5500 if all the plans in the group, (1) are individual account plans or defined contribution plans; (2) have the same trustee, the same named fiduciary (or named fiduciaries) under ERISA, and the same administrator; (3) use the same plan year; and

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IRC section 414(g) and ERISA section 3(16), plan administrator generally means the person specifically so designated by the terms of the plan document. In the absence of a designation, the plan administrator generally is (1) in the case of a plan maintained by a single employer, the employer, (2) in the case of a plan maintained by an employee organization, the employee organization, or (3) in the case of a plan maintained by two or more employers or jointly by one or more employers and one or more employee organizations, the association, committee, joint board of trustees, or other similar group of representatives of the parties that maintain the plan. Under ERISA, the party described in (1), (2) or (3) is referred to as the “plan sponsor.” Note that ERISA applies to employee welfare benefit plans, such as health plans, of private employers, as well as to employer-sponsored retirement (or pension) plans. Employer-sponsored welfare and pension plans are both referred to under ERISA as employee benefit plans. Under ERISA section 4(b)(1) and (2), governmental plans and church plans are generally exempt from ERISA.

<sup>275</sup> ERISA sections 103 and 104. Under ERISA section 4065, the plan administrator of certain defined benefit plans must provide information to the PBGC.

<sup>276</sup> Information is shared also with the PBGC, as applicable. Form 5500 filings are also publicly released in accordance with IRC section 6104(b) and Treas. Reg. section 301.6104(b)-1 and ERISA sections 104(a)(1) and 106(a). Under IRC sections 6011(a) and (e), the IRS is required to provide standards for electronically filed returns, but may not require a person to file a return electronically unless the person is required to file at least 250 returns during the calendar year (“250 return threshold for electronic filing”). Under Treas. Reg. section 301.6058-2, Form 5500 for a plan year must be filed electronically if the filer is required to file at least 250 tax returns (including information returns) during the calendar year that includes the first day of the plan year.

<sup>277</sup> Joint Committee on Taxation, Description of the Chairman’s Amendment in the Nature of a Substitute to H.R. 1994, the “Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019,” JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, p. 59.

<sup>278</sup> For purposes of applying the 250 return threshold for electronic filing to Forms 5500 for plan years beginning after December 31, 2019, information regarding each plan for which information is provided on the Form 5500 is treated as a separate return.

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(4) provide the same investments or investment options to participants and beneficiaries.<sup>279</sup>

Effective Dates

The required modification to the federal Form 5500 must be implemented no later than January 1, 2022, and shall be effective for returns and reports for plan years beginning after December 31, 2021.

California Law (R&TC section 18631(c))

Under the Administration of Franchise and Income Tax Law (AFITL), R&TC section 18631(c) provides the specific federal information returns that must also be filed with the FTB. While California generally conforms to the federal rules related to qualified retirement plans, there is no California requirement to provide the federal Form 5500 to the FTB.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
205	Modification of Nondiscrimination Rules to Protect Older, Longer Service Participants

Background

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>280</sup>

In General

Qualified retirement plans are subject to nondiscrimination requirements, under which the group of employees covered by a plan (“plan coverage”) and the contributions or benefits provided to employees, including benefits, rights, and features under the plan, must not discriminate in favor of highly compensated employees.<sup>281</sup> The timing of plan amendments must also not have the effect of

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<sup>279</sup> See the Joint Committee on Taxation, Description of the Chairman’s Amendment in the Nature of a Substitute to H.R. 1994, the “Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019,” JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, pp. 59, 60.

<sup>280</sup> Joint Committee on Taxation, Description of the Chairman’s Amendment in the Nature of a Substitute to H.R. 1994, the “Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019,” JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, pp. 66-71.

<sup>281</sup> IRC sections 401(a)(3)-(5) and 410(b). Detailed rules are provided in Treas. Reg. sections 1.401(a)(4)-1 through -13 and sections 1.410(b)-2 through -10. In applying the

discriminating significantly in favor of highly compensated employees. In addition, in the case of a defined benefit plan, the plan must benefit at least the lesser of (1) 50 employees of the employer, or (2) the greater of (a) 40 percent of all employees of the employer or (b) two employees (or one employee if there is only one employee), referred to as the “minimum participation” requirements.<sup>282</sup> These requirements are designed to help ensure that qualified retirement plans achieve the goal of retirement security for both lower and higher paid employees.

For nondiscrimination purposes, an employee generally is treated as highly compensated if the employee (1) was a five-percent owner of the employer at any time during the year or the preceding year, or (2) had compensation for the preceding year in excess of \$125,000 (for 2019).<sup>283</sup> Employees who are not highly compensated are referred to as nonhighly compensated employees.

#### Nondiscriminatory Plan Coverage

Whether plan coverage of employees is nondiscriminatory is determined by calculating a plan’s ratio percentage, that is, the ratio of the percentage of nonhighly compensated employees covered under the plan to the percentage of highly compensated employees covered. For this purpose, certain portions of a defined contribution plan are treated as separate plans to which the plan coverage requirements are applied separately, referred to as mandatory disaggregation. Specifically, the following, if provided under a plan, are treated as separate plans: the portion of a plan consisting of employee elective deferrals, the portion consisting of employer matching contributions, the portion consisting of employer nonelective contributions, and the portion consisting of an employee stock ownership plan (“ESOP”).<sup>284</sup>

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nondiscrimination requirements, certain employees, such as those under age 21 or with less than a year of service, generally may be disregarded. In addition, employees of controlled groups and affiliated service groups under the aggregation rules of sections 414(b), (c), (m) and (o) are treated as employed by a single employer.

<sup>282</sup> IRC section 401(a)(26).

<sup>283</sup> IRC section 414(q). At the election of the employer, employees who are highly compensated based on the amount of their compensation may be limited to employees who were among the top 20 percent of employees based on compensation.

<sup>284</sup> Elective deferrals are contributions that an employee elects to have made to a defined contribution plan that includes a qualified cash or deferred arrangement (a section 401(k) plan) rather than receive the same amount as current compensation. Employer matching contributions are contributions made by an employer only if an employee makes elective deferrals or after-tax employee contributions. Employer nonelective contributions are contributions made by an employer regardless of whether an employee makes elective deferrals or after-tax employee contributions. Under section 4975(e)(7), an ESOP is a defined contribution plan, or portion of a defined contribution plan, that is designated as an ESOP and is designed to invest primarily in employer stock.

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Subject to mandatory disaggregation, different qualified retirement plans may otherwise be aggregated and tested together as a single plan, provided that they use the same plan year. The plan determined under these rules for plan coverage purposes generally is also treated as the plan for purposes of applying the other nondiscrimination requirements.

A plan's coverage is nondiscriminatory if the ratio percentage, as determined above, is 70 percent or greater. If a plan's ratio percentage is less than 70 percent, a multi-part test applies, referred to as the average benefit test. First, the plan must meet a "nondiscriminatory classification requirement," that is, it must cover a group of employees that is reasonable and established under objective business criteria and the plan's ratio percentage must be at or above a level specified in the regulations, which varies depending on the percentage of nonhighly compensated employees in the employer's workforce. In addition, the average benefit percentage test must be satisfied.

Under the average benefit percentage test, in general, the average rate of employer-provided contributions or benefit accruals for all nonhighly compensated employees under all plans of the employer must be at least 70 percent of the average contribution or accrual rate of all highly compensated employees.<sup>285</sup> In applying the average benefit percentage test, elective deferrals made by employees, as well as employer matching and nonelective contributions, are taken into account. Generally, all plans maintained by the employer are taken into account, including ESOPs, regardless of whether plans use the same plan year.

Under a transition rule applicable in the case of the acquisition or disposition of a business, or portion of a business, or a similar transaction, a plan that satisfied the plan coverage requirements before the transaction is deemed to continue to satisfy them for a period after the transaction,<sup>286</sup> provided coverage under the plan is not significantly changed during that period.<sup>287</sup>

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<sup>285</sup> Contribution and benefit rates are generally determined under the rules for nondiscriminatory contributions or benefit accruals, described below. These rules are generally based on benefit accruals under a defined benefit plan, other than accruals attributable to after-tax employee contributions, and contributions allocated to participants' accounts under a defined contribution plan, other than allocations attributable to after-tax employee contributions. (Under these rules, contributions allocated to participants' accounts are referred to as "allocations," with the related rates referred to as "allocation rates," but "contribution rates" is used herein for convenience.) However, as discussed below, benefit accruals can be converted to actuarially equivalent contributions, and contributions can be converted to actuarially equivalent benefit accruals.

<sup>286</sup> It is for the period beginning on date of the transaction and ending on the last day of the first plan year beginning after the date of the transaction.

<sup>287</sup> IRC section 410(b)(6)(C).

## Nondiscriminatory Contributions or Benefit Accruals

### *In General*

There are three general approaches to testing the amount of benefits under qualified retirement plans: (1) design-based safe harbors under which the plan's contribution or benefit accrual formula satisfies certain uniformity standards, (2) a general test, described below, and (3) cross-testing of equivalent contributions or benefit accruals. Employee elective deferrals and employer matching contributions under defined contribution plans are subject to special testing rules and generally are not permitted to be taken into account in determining whether other contributions or benefits are nondiscriminatory.<sup>288</sup>

The nondiscrimination rules allow contributions and benefit accruals to be provided to highly compensated and nonhighly compensated employees at the same percentage of compensation.<sup>289</sup> Thus, the various testing approaches described below are generally applied to the amount of contributions or accruals provided as a percentage of compensation, referred to as a contribution rate or accrual rate. In addition, under the "permitted disparity" rules, in calculating an employee's contribution or accrual rate, credit may be given for the employer paid portion of Social Security taxes or benefits.<sup>290</sup> The permitted disparity rules do not apply in testing whether elective deferrals, matching contributions, or ESOP contributions are nondiscriminatory.

The general test is generally satisfied by measuring the rate of contribution or benefit accrual for each highly compensated employee to determine if the group of employees with the same or higher rate (a "rate" group) is a nondiscriminatory group, using the nondiscriminatory plan coverage standards described above. For this purpose, if the ratio percentage of a rate group is less than 70 percent, a simplified standard applies, which includes disregarding the reasonable classification requirement, but requires satisfaction of the average benefit percentage test.

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<sup>288</sup> IRC sections 401(k) and (m), the latter of which applies also to after-tax employee contributions under a defined contribution plan.

<sup>289</sup> For this purpose, under section 401(a)(17), annual compensation generally is limited to \$280,000 per year (for 2019).

<sup>290</sup> See sections 401(a)(5)(C) and (D) and 401(l) and Treas. Reg. sections 1.401(a)(4)-7 and 1.401(l)-1 through -6 for rules for determining the amount of contributions or benefits that can be attributed to the employer-paid portion of Social Security taxes or benefits.



### *Cross-Testing*

Cross-testing involves the conversion of contributions under a defined contribution plan or benefit accruals under a defined benefit plan to actuarially equivalent accruals or contributions, with the resulting equivalencies tested under the general test. However, employee elective deferrals and employer matching contributions under defined contribution plans are not permitted to be taken into account for this purpose, and cross-testing of contributions under a defined contribution plan, or cross-testing of a defined contribution plan aggregated with a defined benefit plan, is permitted only if certain threshold requirements are satisfied.

In order for a defined contribution plan to be tested on an equivalent benefit accrual basis, one of the following three threshold conditions must be met:

- The plan has broadly available allocation rates, that is, each allocation rate under the plan is available to a nondiscriminatory group of employees (disregarding certain permitted additional contributions provided to employees as a replacement for benefits under a frozen defined benefit plan, as discussed below);
- The plan provides allocations that meet prescribed designs under which allocations gradually increase with age or service or are expected to provide a target level of annuity benefit; or
- The plan satisfies a minimum allocation gateway, under which each nonhighly compensated employee has an allocation rate of (a) at least one-third of the highest rate for any highly compensated employee, or (b) if less, at least five percent.

In order for an aggregated defined contribution and defined benefit plan to be tested on an aggregate equivalent benefit accrual basis, one of the following three threshold conditions must be met:

- The plan must be primarily defined benefit in character, that is, for more than fifty percent of the nonhighly compensated employees under the plan, their accrual rate under the defined benefit plan exceeds their equivalent accrual rate under the defined contribution plan;
- The plan consists of broadly available separate defined benefit and defined contribution plans, that is, the defined benefit plan and the defined contribution plan would separately satisfy simplified versions of the minimum coverage and nondiscriminatory amount requirements; or
- The plan satisfies a minimum aggregate allocation gateway, under which each nonhighly compensated employee has an aggregate allocation rate (consisting of allocations under the defined contribution



plan and equivalent allocations under the defined benefit plan) of (a) at least one-third of the highest aggregate allocation rate for any nonhighly compensated employee, or (b) if less, at least five percent in the case of a highest nonhighly compensated employee's rate up to 25 percent, increased by one percentage point for each five-percentage-point increment (or portion thereof) above 25 percent, subject to a maximum of 7.5 percent.

### *Benefits, Rights, and Features*

Each benefit, right, or feature offered under the plan generally must be available to a group of employees that has a ratio percentage that satisfies the minimum coverage requirements, including the reasonable classification requirement if applicable, except that the average benefit percentage test does not have to be met, even if the ratio percentage is less than 70 percent.

### *Multiple Employer and Section 403(b) Plans*

A multiple employer plan generally is a single plan maintained by two or more unrelated employers, that is, employers that are not treated as a single employer under the aggregation rules for related entities.<sup>291</sup> The plan coverage and other nondiscrimination requirements are applied separately to the portions of a multiple employer plan covering employees of different employers.<sup>292</sup>

Certain tax-exempt charitable organizations may offer their employees a tax-deferred annuity plan ("section 403(b) plan").<sup>293</sup> The nondiscrimination requirements, other than the requirements applicable to elective deferrals, generally apply to section 403(b) plans of private tax-exempt organizations. For purposes of applying the nondiscrimination requirements to a section 403(b) plan, subject to mandatory disaggregation, a qualified retirement plan may be combined with the section 403(b) plan and treated as a single plan.<sup>294</sup> However, a section 403(b) plan and qualified retirement plan may not be

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<sup>291</sup> IRC section 413(c). Multiple employer status does not apply if the plan is a multiemployer plan, defined under section 414(f) as a plan maintained pursuant to one or more collective bargaining agreements with two or more unrelated employers and to which the employers are required to contribute under the collective bargaining agreement(s). Multiemployer plans are also known as Taft-Hartley plans.

<sup>292</sup> Treas. Reg. section 1.413-2(a)(3)(ii)-(iii).

<sup>293</sup> IRC section 403(b). These plans are available to employers that are tax-exempt under section 501(c)(3), as well as to employers that are educational institutions of State or local governments.

<sup>294</sup> Treas. Reg. section 1.410(b)-7(f).

treated as a single plan for purposes of applying the nondiscrimination requirements to the qualified retirement plan.

#### Closed and Frozen Defined Benefit Plans

A defined benefit plan may be amended to limit participation in the plan to individuals who are employees as of a certain date. That is, employees hired after that date are not eligible to participate in the plan. Such a plan is sometimes referred to as a “closed” defined benefit plan (that is, closed to new entrants). In such a case, it is common for the employer also to maintain a defined contribution plan and to provide employer matching or nonelective contributions only to employees not covered by the defined benefit plan or at a higher rate to such employees.

Over time, the group of employees continuing to accrue benefits under the defined benefit plan may come to consist more heavily of highly compensated employees, for example, because of greater turnover among nonhighly compensated employees or because increasing compensation causes nonhighly compensated employees to become highly compensated. In that case, the defined benefit plan may have to be combined with the defined contribution plan and tested on a benefit accrual basis. However, under the regulations, if none of the threshold conditions is met, testing on a benefits basis may not be available. Notwithstanding the regulations, recent IRS guidance provides relief for a limited period, allowing certain closed defined benefit plans to be aggregated with a defined contribution plan and tested on an aggregate equivalent benefits basis without meeting any of the threshold conditions.<sup>295</sup> When the group of employees continuing to accrue benefits under a closed defined benefit plan consists more heavily of highly compensated employees, the benefits, rights, and features provided under the plan may also fail the tests under the existing nondiscrimination rules.

In some cases, if a defined benefit plan is amended to cease future accruals for all participants, referred to as a “frozen” defined benefit plan, additional contributions to a defined contribution plan may be provided for participants, in particular for older participants, in order to make up in part for the loss of the benefits they expected to earn under the defined benefit plan (“make-whole” contributions). As a practical matter, testing on a benefit accrual basis may be

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<sup>295</sup> Notice 2014-5, 2014-2 IRB 276, December 13, 2013 extended by Notice 2015-28, 2015-14 IRB 848, March 19, 2015, Notice 2016-57, 2016-40 IRB 432, September 19, 2016, and most recently by Notice 2017-45, 2017-38 IRB 232, August 31, 2017. Proposed regulations revising the nondiscrimination requirements for closed plans were also issued in 2016, subject to various conditions. 81 Fed. Reg. 4976 (January 29, 2016).

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required in that case, but may not be available because the defined contribution plan does not meet any of the threshold conditions.”

New Federal Law (IRC section 401)

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>296</sup>

Closed or Frozen Defined Benefit Plans

*In General*

The proposal provides nondiscrimination relief with respect to benefits, rights, and features for a closed class of participants (“closed class”),<sup>297</sup> and with respect to benefit accruals for a closed class, under a defined benefit plan that meets the requirements described below (referred to herein as an “applicable” defined benefit plan). In addition, the proposal treats a closed or frozen applicable defined benefit plan as meeting the minimum participation requirements if the plan met the requirements as of the effective date of the plan amendment by which the plan was closed or frozen.

If a portion of an applicable defined benefit plan eligible for relief under the proposal is spun off to another employer, and if the spun-off plan continues to satisfy any ongoing requirements applicable for the relevant relief as described below, the relevant relief for the spun-off plan will continue with respect to the other employer.

*Benefits, Rights, or Features for a Closed Class*

Under the proposal, an applicable defined benefit plan that provides benefits, rights, or features to a closed class does not fail the nondiscrimination requirements by reason of the composition of the closed class, or the benefits, rights, or features provided to the closed class, if (1) for the plan year as of which the class closes and the two succeeding plan years, the benefits, rights, and features satisfy the nondiscrimination requirements without regard to the relief under the proposal, but taking into account the special testing rules described below,<sup>298</sup> (2) after the date as of which the class was closed, any plan amendment modifying the closed class or the benefits, rights, and

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<sup>296</sup> Joint Committee on Taxation, Description of the Chairman’s Amendment in the Nature of a Substitute to H.R. 1994, the “Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019,” JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, pp. 71-75.

<sup>297</sup> References under the proposal to a closed class of participants and similar references to a closed class include arrangements under which one or more classes of participants are closed, except that one or more classes of participants closed on different dates are not aggregated for purposes of determining the date any such class was closed.

<sup>298</sup> Other testing options available under present law are also available for this purpose.

features provided to the closed class does not discriminate significantly in favor of highly compensated employees.

For purposes of requirement (1) above, the following special testing rules apply:

- In applying the plan coverage transition rule for business acquisitions, dispositions, and similar transactions, the closing of the class of participants is not treated as a significant change in coverage;
- Two or more plans do not fail to be eligible to be treated as a single plan solely by reason of having different plan years;<sup>299</sup> and
- Changes in employee population are disregarded to the extent attributable to individuals who become employees or cease to be employees, after the date the class is closed, by reason of a merger, acquisition, divestiture, or similar event.

#### *Benefit Accruals for a Closed Class*

Under the proposal, an applicable defined benefit plan that provides benefits to a closed class may be aggregated, that is, treated as a single plan, and tested on a benefit accrual basis with one or more defined contribution plans (without having to satisfy the threshold conditions under present law) if (1) for the plan year as of which the class closes and the two succeeding plan years, the plan satisfies the plan coverage and nondiscrimination requirements without regard to the relief under the proposal, but taking into account the special testing rules described above,<sup>300</sup> and (2) after the date as of which the class was closed, any plan amendment modifying the closed class or the benefits provided to the closed class does not discriminate significantly in favor of highly compensated employees.

Under the proposal, defined contribution plans that may be aggregated with an applicable defined benefit plan and treated as a single plan include the portion of one or more defined contribution plans consisting of matching contributions, an ESOP, or matching or nonelective contributions under a section 403(b) plan. If an applicable defined benefit plan is aggregated with the portion of a defined contribution plan consisting of matching contributions, any portion of the defined contribution plan consisting of elective deferrals must also be aggregated. In addition, the matching contributions are treated in the same manner as nonelective contributions, including for purposes of permitted disparity.

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<sup>299</sup> This rule applies also for purposes of applying the plan coverage and other nondiscrimination requirements to an applicable defined benefit plan and one or more defined contributions that, under the proposal, may be treated as a single plan as described below.

<sup>300</sup> Other testing options available under present law are also available for this purpose.

## Applicable Defined Benefit Plan

An applicable defined benefit plan to which relief under the proposal applies is a defined benefit plan under which the class was closed (or the plan frozen) before April 5, 2017, or that meets the following alternative conditions:

(1) taking into account any predecessor plan, the plan has been in effect for at least five years as of the date the class is closed (or the plan is frozen) and (2) under the plan, during the five-year period preceding that date, (a) for purposes of the relief provided with respect to benefits, rights, and features for a closed class, there has not been a substantial increase in the coverage or value of the benefits, rights, or features, or (b) for purposes of the relief provided with respect to benefit accruals for a closed class or the minimum participation requirements, there has not been a substantial increase in the coverage or benefits under the plan.

For purposes of (2)(a) above, a plan is treated as having a substantial increase in coverage or value of benefits, rights, or features only if, during the applicable five-year period, either the number of participants covered by the benefits, rights, or features on the date the period ends is more than 50 percent greater than the number on the first day of the plan year in which the period began, or the benefits, rights, and features have been modified by one or more plan amendments in such a way that, as of the date the class is closed, the value of the benefits, rights, and features to the closed class as a whole is substantially greater than the value as of the first day of the five-year period, solely as a result of the amendments.

For purposes of (2)(b) above, a plan is treated as having had a substantial increase in coverage or benefits only if, during the applicable five-year period, either the number of participants benefiting under the plan on the date the period ends is more than 50 percent greater than the number of participants on the first day of the plan year in which the period began, or the average benefit provided to participants on the date the period ends is more than 50 percent greater than the average benefit provided on the first day of the plan year in which the period began. In applying this requirement, the average benefit provided to participants under the plan is treated as having remained the same between the two relevant dates if the benefit formula applicable to the participants has not changed between the dates and, if the benefit formula has changed, the average benefit under the plan is considered to have increased by more than 50 percent only if the target normal cost for all participants benefiting under the plan for the plan year in which the five-year period ends exceeds the target normal cost for all such participants for that plan year if determined using the benefit formula in effect for the participants for the first plan year in the five-year period by more than

50 percent.<sup>301</sup> In applying these rules, a multiple employer plan is treated as a single plan, rather than as separate plans separately covering the employees of each participating employer.

In applying these standards, any increase in coverage or value, or in coverage or benefits, whichever is applicable, is generally disregarded if it is attributable to coverage and value, or coverage and benefits, provided to employees who (1) became participants as a result of a merger, acquisition, or similar event that occurred during the 7-year period preceding the date the class was closed, or (2) became participants by reason of a merger of the plan with another plan that had been in effect for at least five years as of the date of the merger and, in the case of benefits, rights, or features for a closed class, under the merger, the benefits, rights, or features under one plan were conformed to the benefits, rights, or features under the other plan prospectively.

#### Make-whole Contributions under a Defined Contribution Plan

Under the proposal, a defined contribution plan is permitted to be tested on an equivalent benefit accrual basis (without having to satisfy the threshold conditions under present law) if the following requirements are met:

- The plan provides make-whole contributions to a closed class of participants whose accruals under a defined benefit plan have been reduced or ended (“make-whole class”);
- For the plan year of the defined contribution plan as of which the make-whole class closes and the two succeeding plan years, the make-whole class satisfies the nondiscriminatory classification requirement under the plan coverage rules, taking into account the special testing rules described above;
- After the date as of which the class was closed, any amendment to the defined contribution plan modifying the make-whole class or the allocations, benefits, rights, and features provided to the make-whole class does not discriminate significantly in favor of highly compensated employees; and
- Either the class was closed before April 5, 2017, or the defined benefit plan is an applicable defined benefit plan under the alternative

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<sup>301</sup> Under the funding requirements applicable to defined benefit plans, target normal cost for a plan year (defined in section 430(b)(1)(A)(i)) is generally the sum of the present value of the benefits expected to be earned under the plan during the plan year plus the amount of plan-related expenses to be paid from plan assets during the plan year. Under the proposal, in applying this average benefit rule to certain defined benefit plans maintained by cooperative organizations and charities, referred to as CSEC plans (defined in section 414(y)), which are subject to different funding requirements, the CSEC plan’s normal cost under IRC section 433(j)(1)(B) is used instead of target normal cost.



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conditions applicable for purposes of the relief provided with respect to benefit accruals for a closed class.

With respect to one or more defined contribution plans meeting the requirements above, in applying the plan coverage and nondiscrimination requirements, the portion of the plan providing make-whole or other nonelective contributions may also be aggregated and tested on an equivalent benefit accrual basis with the portion of one or more other defined contribution plans consisting of matching contributions, an ESOP, or matching or nonelective contributions under a section 403(b) plan. If the plan is aggregated with the portion of a defined contribution plan consisting of matching contributions, any portion of the defined contribution plan consisting of elective deferrals must also be aggregated. In addition, the matching contributions are treated in the same manner as nonelective contributions, including for purposes of permitted disparity.

Under the proposal, “make-whole contributions” generally means nonelective contributions for each employee in the make-whole class that are reasonably calculated, in a consistent manner, to replace some or all of the retirement benefits that the employee would have received under the defined benefit plan and any other plan or qualified cash or deferred arrangement under a section 401(k) plan if no change had been made to the defined benefit plan and other plan or arrangement.<sup>302</sup> However, under a special rule, in the case of a defined contribution plan that provides benefits, rights, or features to a closed class of participants whose accruals under a defined benefit plan have been reduced or eliminated, the plan will not fail to satisfy the nondiscrimination requirements solely by reason of the composition of the closed class, or the benefits, rights, or features provided to the closed class, if the defined contribution plan and defined benefit plan otherwise meet the requirements described above but for the fact that the make-whole contributions under the defined contribution plan are made in whole or in part through matching contributions.

If a portion of a defined contribution plan eligible for relief under the proposal is spun off to another employer, and if the spun-off plan continues to satisfy any ongoing requirements applicable for the relevant relief as described above, the relevant relief for the spun-off plan will continue with respect to the other employer.”

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<sup>302</sup> For this purpose, consistency is not required with respect to employees who were subject to different benefit formulas under the defined benefit plan.



### Effective Date

The April 1, 2019, dated *Description of The Chairman's Amendment in the Nature of a Substitute to H.R. 1994, The "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019"* report (JCX-13-19) by the Joint Committee on Taxation states:

The provision is generally effective on the date of enactment, without regard to whether any plan modifications referred to in the provision are adopted or effective before, on, or after the date of enactment [December 20, 2019].

However, at the election of a plan sponsor, the provision will apply to plan years beginning after December 31, 2013. For purposes of the provision, a closed class of participants under a defined benefit plan is treated as being closed before April 5, 2017, if the plan sponsor's intention to create the closed class is reflected in formal written documents and communicated to participants before that date. In addition, a plan does not fail to be eligible for the relief under the proposal solely because (1) in the case of benefits, rights, or features for a closed class under a defined benefit plan, the plan was amended before the date of enactment to eliminate one or more benefits, rights, or features and is further amended after the date of enactment to provide the previously eliminated benefits, rights, or features to a closed class of participants, or (2) in the case of benefit accruals for a closed class under a defined benefit plan or application of the minimum benefit requirements to a closed or frozen defined benefit plan, the plan was amended before the date of the enactment to cease all benefit accruals and is further amended after the date of enactment to provide benefit accruals to a closed class of participants. In either case, the relevant relief applies only if the plan otherwise meets the requirements for the relief, and, in applying the relevant relief, the date the class of participants is closed is the effective date of the later amendment.<sup>303</sup>

### California Law (R&TC sections 17501 and 24601)

California's PITL and CTL generally conform by reference to the federal rules related to the modification of nondiscrimination rules related to the qualified retirement plans under IRC sections 401-420 and 430-436 as of the "specified date" of January 1, 2015. However, both the PITL and CTL additionally provide that federal changes to IRC these sections apply without regard to taxable year to the same extent as applicable for federal income tax purposes. In other words, both the PITL and CTL automatically

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<sup>303</sup> Joint Committee on Taxation, *Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019,"* JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, pp. 75-76.

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conform to these federal changes. As a result, these modifications automatically apply under California law.

Impact on California Revenue

Baseline.

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Title III — Other Benefits

<u>Section</u>	<u>Section Title</u>
301	Benefits Provided to Volunteer Firefighters and Emergency Medical Responders

Background

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>304</sup>

Benefits for Volunteer Firefighters and Emergency Medical Responders

In general, a reduction in property tax by persons who volunteer their services as emergency responders under a state law program is includible in gross income.<sup>305</sup> However, for taxable years beginning after December 31, 2007, and before January 1, 2011, an exclusion applied for any qualified state or local tax benefit and any qualified reimbursement payment provided to members of qualified volunteer emergency response organizations.<sup>306</sup>

A qualified volunteer emergency response organization is a volunteer organization that is organized and operated to provide firefighting or emergency medical services for persons in a state or a political subdivision and is required (by written agreement) by the state or political subdivision to furnish firefighting or emergency medical services in the state or political subdivision.

A qualified state or local tax benefit is any reduction or rebate of certain taxes provided by a state or local government on account of services performed by individuals as members of a qualified volunteer emergency response organization. These taxes are limited to state or local income taxes, state or local real property taxes, and state or local personal property taxes. A qualified reimbursement payment is a payment provided by a State or political subdivision thereof on account of reimbursement for expenses incurred in connection with the performance of services as a member of a qualified volunteer emergency response organization. The amount of excludible qualified reimbursement payments is limited to \$30 for each month during which a volunteer performs services.

Itemized Deductions

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<sup>304</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, pp. 80-81.

<sup>305</sup> IRS Chief Counsel Advice 200302045 (December 3, 2002).

<sup>306</sup> IRC section 139B. Under section 3121(a)(23), the exclusion applied also for purposes of taxes under the Federal Insurance Contributions Act (FICA).

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Subject to certain limitations, individuals are allowed itemized deductions for (1) state and local income taxes, real property taxes, and personal property taxes, and (2) contributions to charitable organizations, including unreimbursed expenses incurred in performing volunteer services for such an organization.<sup>307</sup>

The amount of state or local taxes taken into account in determining the deduction for taxes is reduced by the amount of any excludible qualified State or local tax benefit. Similarly, expenses paid or incurred by an individual in connection with the performance of services as a member of a qualified volunteer emergency response organization are taken into account for purposes of the charitable deduction only to the extent the expenses exceed the amount of any excludible qualified reimbursement payment.

New Federal Law (IRC section 139B)

“The provision reinstates for one year [taxable years beginning after December 31, 2019, and before December 31, 2020,] the exclusions for qualified state or local tax benefits and qualified reimbursement payments provided to members of qualified volunteer emergency response organizations. The provision also increases the exclusion for qualified reimbursement payments to \$50 for each month [rather than \$30] during which a volunteer performs services. Under the provision, the exclusions for qualified state or local tax benefits and qualified reimbursement payments do not apply for taxable years beginning after December 31, 2020.”<sup>308</sup>

Effective Date

The amendments made by this provision are no longer effective for taxable years beginning after December 31, 2020. Thus, the exclusions apply only for taxable years beginning during 2020.<sup>309</sup>

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<sup>307</sup> IRC sections 164(a) and 170.

<sup>308</sup> Joint Committee on Taxation, Description of the Chairman’s Amendment in the Nature of a Substitute to H.R. 1994, the “Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019,” JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, p. 81.

<sup>309</sup> See the Joint Committee on Taxation, Description of the Chairman’s Amendment in the Nature of a Substitute to H.R. 1994, the “Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019,” JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, p. 81.

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California Law (None)

California does not conform to IRC section 139B, allowing for the exclusion of qualified state or local tax benefits and qualified reimbursement payments provided to members of qualified volunteer emergency response organizations.

Impact on California Revenue

Estimated Conformity Revenue Impact of The One-Year Exclusion Provided to Members of Qualified Volunteer Emergency Response Organizations

For Taxable Years Beginning On or After January 1, 2020

Enactment Assumed After June 30, 2020

2019-2020	2020-2021	2021-2022	2022-2023
N/A	-\$1,600,000	N/A	N/A

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<u>Section</u>	<u>Section Title</u>
302	Expansion of Section 529 Plans

Background

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>310</sup>

In general

A qualified tuition program (often referred to as a "529 plan") is a program established and maintained by a State or agency or instrumentality thereof, or by one or more eligible educational institutions, which satisfies certain requirements and under which a person may purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary (a "prepaid tuition program"). Section 529 provides specified income tax and transfer tax rules for the treatment of accounts and contracts established under qualified tuition programs.<sup>311</sup> In the case of a program

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<sup>310</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, pp. 82, 83.

<sup>311</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.

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 who is not the designated beneficiary. Qualified tuition accounts or contracts generally require the designation of a person (generally referred to as an “account owner”)<sup>312</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 oftentimes is not the contributor or the designated beneficiary), and an administrator of the account or contract.

#### Qualified Higher Education Expenses

Distributions for the purpose of meeting the designated beneficiary’s higher education expenses are generally not subject to tax. For purposes of receiving a distribution from a qualified tuition program that qualifies for this favorable tax treatment, the term 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

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<sup>312</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.

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 half-time. Qualified higher education expenses include the purchase of any computer technology or equipment, or Internet access or related services, if such technology or services are to be used primarily by the beneficiary during any of the years a beneficiary is enrolled at an eligible institution.

For distributions made after December 31, 2017, a designated beneficiary may, on an annual basis, receive up to \$10,000 in aggregate 529 distributions to be used in connection with expenses for tuition in connection with enrollment or attendance at an elementary or secondary public, private, or religious school. To the extent such distributions do not exceed \$10,000, they are treated in the same manner as distributions for qualified higher education expenses.

#### 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.

#### Deduction for Interest on Education Loans

Certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses, subject to a maximum annual deduction limit of \$2,500.<sup>313</sup> For 2019, the deduction is phased out ratably for taxpayers with modified AGI between \$70,000 and

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<sup>313</sup> IRC section 221.



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\$85,000 (\$140,000 and \$170,000 for married taxpayers filing a joint return). The income phase-out ranges are indexed for inflation.

A qualified education loan generally is defined as any indebtedness incurred solely to pay for the costs of attendance (including room and board) of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred in attending on at least a half-time basis (1) eligible educational institutions, or (2) institutions conducting internship or residency programs leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training. The cost of attendance is reduced by any amount excluded from gross income under the exclusions for qualified scholarships and tuition reductions, employer-provided educational assistance, interest earned on education savings bonds, qualified tuition programs, and Coverdell education savings accounts, as well as the amount of certain other scholarships and similar payments.

New Federal Law (IRC sections 221(e) and 529(c))

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>314</sup>

The provision makes two modifications to section 529 plans.

First, the provision allows tax-free treatment applicable to distributions for higher education expenses to apply to expenses for fees, books, supplies, and equipment required for the participation of a designated beneficiary in an apprenticeship program. The apprenticeship program must be registered and certified with the Secretary of Labor under section 1 of the National Apprenticeship Act.<sup>315</sup>

Second, the provision allows tax-free treatment to apply to distributions of certain amounts used to make payments on principal or interest of a qualified education loan. No individual may receive more than \$10,000 of such distributions, in aggregate, over the course of the individual's lifetime.<sup>316</sup> To the extent that an individual receives in excess of \$10,000 of such distributions, they are subject to the usual tax treatment of 529 distributions (i.e., the earnings are included in income and subject to a 10-percent penalty). The provision contains a special rule allowing such amounts to be distributed to a sibling of a

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<sup>314</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, pp. 82, 83.

<sup>315</sup> 29 U.S.C. 50.

<sup>316</sup> This limitation applies to such distributions from all 529 accounts. Thus, an individual may not avoid the limitation by receiving separate \$10,000 distributions from multiple 529 accounts.

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designated beneficiary (i.e., a brother, sister, stepbrother, or stepsister). This rule allows a 529 account holder to make a student loan distribution to a sibling of the designated beneficiary without changing the designated beneficiary of the account. For purposes of the \$10,000 lifetime limit on student loan distributions, a distribution to a sibling of a designated beneficiary is applied towards the sibling's lifetime limit, and not the designated beneficiary's lifetime limit. The deduction available for interest paid by the taxpayer during the taxable year on any qualified education loan is disallowed to the extent such interest was paid from a tax-free distribution from a 529 plan.

Effective Date

The provision amendments apply to distributions made after December 31, 2018.

California Law (R&TC sections 17201, 17140, and 17140.3)

California's PITL generally conform by reference to the federal rules related to the student loan interest deduction and the qualified state tuition program rules under IRC sections 221 and 529 as of the "specified date" of January 1, 2015. However, R&TC sections 17201, 17410, and 17140.3 do not provide that federal changes to the IRC with respect to these sections apply without regard to taxable year to the same extent as applicable for federal income tax purposes. In other words, these PITL sections do not automatically conform to federal changes. As a result, these modifications do not automatically apply under California law. Distributions made pursuant to these federal modifications would be includable in California taxable income and subject to 2.5 percent premature distribution penalty.

Impact on California Revenue

Estimated Conformity Revenue Impact of Expansion of Section 529 Plans  
For Taxable Years Beginning On or After January 1, 2020

Enactment Assumed After June 30, 2020

2019-2020	2020-2021	2021-2022	2022-2023
N/A	-\$1,600,000	-\$900,000	-\$1,000,000

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Title IV — Revenue Provisions

Section      Section Title

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401 Modification of Required Distribution Rules for Designated Beneficiaries

Background

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>317</sup>

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<sup>317</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, pp. 86-90.

## In General

Minimum distribution rules apply to tax-favored employer-sponsored retirement plans and IRAs.<sup>318</sup> Employer-sponsored retirement plans are of two general types: defined benefit plans, under which benefits are determined under a plan formula and paid from general plan assets, rather than individual accounts; and defined contribution plans, under which benefits are based on a separate account for each participant, to which are allocated contributions, earnings, and losses.

In general, under the minimum distribution rules, distribution of minimum benefits must begin to an employee (or IRA owner) no later than a required beginning date and a minimum amount must be distributed each year (sometimes referred to as 'lifetime' minimum distribution requirements). These lifetime requirements do not apply to a Roth IRA.<sup>319</sup> Minimum distribution rules also apply to benefits payable with respect to an employee (or IRA owner) who has died (sometimes referred to as 'after-death' minimum distribution requirements). The regulations provide a methodology for calculating the required minimum distribution from an individual account under a defined contribution plan or from an IRA.<sup>320</sup> In the case of annuity payments under a defined benefit plan or an annuity contract, the regulations provide requirements that the stream of annuity payments must satisfy.

Failure to comply with the minimum distribution requirement results in an excise tax imposed on the individual who was required to take the distributions equal to 50 percent of the required minimum amount not distributed for the year.<sup>321</sup> The excise tax may be waived in certain cases. For employer-sponsored retirement plans, satisfying the minimum distribution requirement under the plan terms and in operation is also a requirement for tax-favored treatment.

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<sup>318</sup> IRC sections 401(a)(9), 403(b)(1), 408(a)(6), 408(b)(3), and 457(d)(2). Tax-favored employer-sponsored retirement plans include qualified retirement plans and annuities under sections 401(a) and 403(a), tax-deferred annuity plans under section 403(b), and governmental eligible deferred compensation plans under section 457(b). Minimum distribution requirements also apply to eligible deferred compensation plans under section 457(b) of tax-exempt employers.

<sup>319</sup> IRC section 408A(c)(5).

<sup>320</sup> Reflecting the directive in section 823 of the Pension Protection Act of 2006 (P.L. No. 109-280), pursuant to Treas. Reg. section 1.401(a)(9)-1, A-2(d), a governmental plan within the meaning of section 414(d) or a governmental eligible deferred compensation plan is treated as having complied with the statutory minimum distribution rules if the plan complies with a reasonable and good faith interpretation of those rules.

<sup>321</sup> IRC section 4974.

## Required Beginning Date

For traditional IRAs, the required beginning date is April 1 following the calendar year in which the employee (or IRA owner) attains age 70½. For employer-sponsored retirement plans, for an employee other than an employee who is a five-percent owner in the year the employee attains age 70½, the required beginning date is April 1 after the later of the calendar year in which the employee attains age 70½ or retires. For an employee who is a five-percent owner under an employer-sponsored tax-favored retirement plan in the year the employee attains age 70½, the required beginning date is the same as for IRAs even if the employee continues to work past age 70½.

## Lifetime Rules

While an employee (or IRA owner) is alive, distributions of the individual's interest are required to be made (in accordance with regulations) over the life or life expectancy of the employee (or IRA owner), or over the joint lives or joint life expectancy of the employee (or IRA owner) and a designated beneficiary.<sup>322</sup> For defined contribution plans and IRAs, the required minimum distribution for each year is determined by dividing the account balance as of the end of the prior year by a distribution period which, while the employee (or IRA owner) is alive, is the factor for the employee (or IRA owner's) age from the uniform lifetime table included in the Treasury Regulations.<sup>323</sup> The distribution period for annuity payments under a defined benefit plan or annuity contract (to the extent not limited to the life of the employee (or IRA owner) or the joint lives of the employee (or IRA owner) and a designated beneficiary) is generally subject to the same limitations as apply to individual accounts.

## After-death Rules

### *Payments over a Distribution Period*

The after-death minimum distributions rules vary depending on (i) whether an employee (or IRA owner) dies on or after the required beginning date or before the required beginning date, and (ii) whether there is a designated

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<sup>322</sup> IRC section 401(a)(9)(A).

<sup>323</sup> Treas. Reg. section 1.401(a)(9)-5. This table is based on the joint life and last survivor expectancy of the individual and a hypothetical beneficiary 10 years younger. For an individual with a spouse as designated beneficiary who is more than 10 years younger (and thus the number of years in the couple's joint life and last survivor expectancy is greater than the uniform lifetime table), the joint life expectancy and last survivor expectancy of the couple (calculated using the table in the regulations) is used. For this purpose and other special rules that apply to the surviving spouse as beneficiary, a former spouse to whom all or a portion of an employee's benefit is payable pursuant to a qualified domestic relations order (within the meaning of section 414(p)) is treated as the spouse (including a surviving spouse) of the employee for purposes of section 401(a)(9).

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beneficiary for the benefit.<sup>324</sup> Under the regulations, a designated beneficiary is an individual designated as a beneficiary under the plan or IRA.<sup>325</sup> Similar to the lifetime rules, for defined contribution plans and IRAs ('individual accounts'), the required minimum distribution for each year after the death of the employee (or IRA owner) is generally determined by dividing the account balance as of the end of the prior year by a distribution period.

If an employee (or IRA owner) dies on or after the required beginning date, the basic statutory rule is that the remaining interest must be distributed at least as rapidly as under the method of distribution being used before death.<sup>326</sup> Under the regulations, for individual accounts, this rule is also interpreted as requiring the minimum required distribution to be calculated using a distribution period. If there is no designated beneficiary, the distribution period is equal to the remaining years of the employee's (or IRA owner's) life, as of the year of death.<sup>327</sup> If there is a designated beneficiary, the distribution period (if longer) is the beneficiary's life expectancy calculated using the life expectancy table in the regulations, determined in the year after the year of death.<sup>328</sup>

If an employee (or IRA owner) dies before the required beginning date and any portion of the benefit is payable to a designated beneficiary, the statutory rule is that distributions are generally required to begin within one year of the employee's (or IRA owner's) death (or such later date as prescribed in regulations) and are permitted to be paid (in accordance with regulations) over the life or life expectancy of the designated beneficiary. If the beneficiary of the employee (or IRA owner) is the individual's surviving spouse, distributions are not required to commence until the year in which the employee (or IRA owner) would have attained age 70½. If the surviving spouse dies before the employee (or IRA owner) would have attained age 70½, the after-death rules apply after the death of the spouse as though the spouse

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<sup>324</sup> In the case of amounts for which the employee or IRA owner's surviving spouse is the beneficiary, the surviving spouse generally is permitted to do a tax-free rollover of such amounts into an IRA (or account of a tax-favored employer-sponsored plan of the spouse's employer) established in the surviving spouse's name as IRA owner or employee. The rules applicable to the rollover account, including the minimum distribution rules, are the same rules that apply to an IRA owner or employee. In the case of an IRA for which the spouse is sole beneficiary, this can be accomplished by simply renaming the IRA as an IRA held by the spouse as IRA owner rather than as a beneficiary.

<sup>325</sup> Treas. Reg. section 1.401(a)(9)-4, A-1. The individual need not be named as long as the individual is identifiable under the terms of the plan (or IRA). There are special rules for multiple beneficiaries and for trusts named as beneficiary (where the beneficiaries of the trust are individuals). However, the fact that an interest under a plan or IRA passes to a certain individual under a will or otherwise under State law does not make that individual a designated beneficiary unless the individual is designated as a beneficiary under the plan or IRA.

<sup>326</sup> IRC section 401(a)(9)(B)(i).

<sup>327</sup> Treas. Reg. section 1.401(a)(9)-5, A-5(a)(2).

<sup>328</sup> Treas. Reg. section 1.401(a)(9)-5, A-5(a)(1).

were the employee (or IRA owner). Under the regulations, for individual accounts, the required minimum distribution for each year is determined using a distribution period and the period is measured by the designated beneficiary's life expectancy, calculated in the same manner as if the individual died on or after the required beginning date.<sup>329</sup>

In cases where distribution after death is based on life expectancy (either the remaining life expectancy of the employee (or IRA owner) or a designated beneficiary), the distribution period generally is fixed at the employee's (or IRA owner's) death and then reduced by one for each year that elapses after the year in which it is calculated. If the designated beneficiary dies during the distribution period, distributions continue to the subsequent beneficiaries over the remaining years in the distribution period.<sup>330</sup>

The distribution period for annuity payments under a defined benefit plan or annuity contract (to the extent not limited to the life of a designated beneficiary) is generally subject to the same limitations as apply to individual accounts.

#### *Five-year Rule*

If an employee (or IRA owner) dies before the required beginning date and there is no designated beneficiary, then the entire remaining interest of the employee (or IRA owner) must generally be distributed by the end of the fifth calendar year following the individual's death.<sup>331</sup>

#### *Defined Benefit Plans and Annuity Distributions*

The regulations provide rules for the amount of annuity distributions from a defined benefit plan, or from an annuity purchased by the plan from an insurance company, that are paid over life or life expectancy. Annuity distributions are generally required to be nonincreasing with certain exceptions, which include, for example, (i) increases to the extent of certain specified cost-of-living indices, (ii) a constant percentage increase (for a qualified defined benefit plan, the constant percentage cannot exceed

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<sup>329</sup> Treas. Reg. section 1.401(a)(9)-5, A-5(b).

<sup>330</sup> If the distribution period is based on the surviving spouse's life expectancy (whether the employee or IRA owner's death is before or after the required beginning date), the spouse's life expectancy generally is recalculated each year while the spouse is alive and then fixed the year after the spouse's death.

<sup>331</sup> IRC section 401(a)(9)(B)(ii) provides that the entire interest must be distributed within five years of the employee's death. Treas. Reg. section 1.401(a)(9)-3, A-2, provides that this requirement is satisfied if the entire interest is distributed by the end of the fifth calendar year following the employee's death. There are provisions in the regulations allowing a designated beneficiary to take advantage of the five-year rule. See Treas. Reg. sections 1.401(a)(9)-4, A-4, and 1.4974-2, A-7(b).



five percent per year), (iii) certain accelerations of payments, and (iv) increases to reflect when an annuity is converted to a single life annuity after the death of the beneficiary under a joint and survivor annuity or after termination of the survivor annuity under a qualified domestic relations order.<sup>332</sup> If distributions are in the form of a joint and survivor annuity and the survivor annuitant both is not the surviving spouse and is younger than the employee (or IRA owner), the survivor annuity benefit is limited to a percentage of the life annuity benefit for the employee (or IRA owner). The survivor benefit as a percentage of the benefit of the primary annuitant is required to be smaller (but not required to be less than 52 percent) as the difference in the ages of the primary annuitant and the survivor annuitant become greater.

#### *Plan Amendment and Anti-cut-back Requirements*

Present law provides a remedial amendment period during which, under certain circumstances, a qualified retirement plan may be amended retroactively in order to comply with the qualification requirements.<sup>333</sup> In general, plan amendments to reflect changes in the law generally must be made by the time prescribed by law for filing the income tax return of the employer for the employer's taxable year in which the change in law occurs. The Secretary may extend the time by which plan amendments need to be made.

The Code and ERISA generally prohibit plan amendment that reduce accrued benefits, including amendments that eliminate or reduce optional forms of benefit with respect to benefits already accrued except to the extent prescribed in regulations.<sup>334</sup> This prohibition on the reduction of accrued benefits is commonly referred to as the "anti-cut-back rule".

#### New Federal Law (IRC section 401)

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>335</sup>

##### Change in After-Death Rules for Defined Contribution Plans

The provision changes the after-death required minimum distribution rules applicable to defined contribution plans, as defined, with respect to required minimum distributions to designated beneficiaries. A defined

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<sup>332</sup> Treas. Reg. section 1.401(a)(9)-6, A-14.

<sup>333</sup> IRC section 401(b).

<sup>334</sup> IRC section 411(d)(6) and ERISA section 204(g).

<sup>335</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, pp. 86-90.

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contribution plan for this purpose means an eligible retirement plan<sup>336</sup> (qualified retirement plans, section 403(b) plans, governmental section 457(b) plans, and IRAs) other than a defined benefit plan.”<sup>337</sup>

### Ten-Year After-death Rule for Defined Contributions Plans

#### *In General*

Under the provision, the five-year rule is expanded to become a 10-year period instead of five years (‘10-year rule’), such that the 10-year rule is the general rule for distributions to designated beneficiaries after death (regardless of whether the employee (or IRA owner) dies before, on, or after the required beginning date) unless the designated beneficiary is an eligible beneficiary as defined in the provision. Thus, in the case of an ineligible beneficiary, distribution of the employee (or IRA owner’s) entire benefit is required to be distributed by the end of the tenth calendar year following the year of the employee or IRA owner’s death.<sup>338</sup>

#### *Eligible Beneficiaries*

For eligible beneficiaries, an exception to the 10-year rule (for death before the required beginning date under present law) applies whether or not the employee (or IRA owner) dies before, on, or after the required beginning date. The exception (similar to present law) generally allows distributions over life or life expectancy of an eligible beneficiary beginning in the year following the year of death. Eligible beneficiaries include any beneficiary who, as of the date of death, is the surviving spouse of the employee (or IRA owner),<sup>339</sup> is disabled, is a chronically ill individual, is an individual who is not more than 10 years younger than the employee (or IRA owner), or is a child of the employee (or IRA

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<sup>336</sup> IRC section 402(c)(8)(B).

<sup>337</sup> Joint Committee on Taxation, Description of the Chairman’s Amendment in the Nature of a Substitute to H.R. 1994, the “Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019,” JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, p. 90.

<sup>338</sup> Joint Committee on Taxation, Description of the Chairman’s Amendment in the Nature of a Substitute to H.R. 1994, the “Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019,” JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, p. 90.

<sup>339</sup> As in the case of the present law special rule in section 401(a)(9)(B)(iv) for surviving spouses, spouse is not defined in the provision. Under Treas. Reg. section 1.401(a)(9)-8, A-5, a spouse is the employee’s spouse under applicable State law. In the case of a special rule for a surviving spouse, that determination is generally made based on the employee’s marital status on the date of death. An exception is provided in Treas. Reg. section 1.401(a)(9)-6, A-6, under which a former spouse to whom all or a portion of the employee’s benefits is payable pursuant to a qualified domestic relations order as defined in section 414(p) is treated as the employee’s spouse (including a surviving spouse). In the case of a qualified joint and survivor annuity under section 401(a)(11) and 417, the spouse is generally determined as of the annuity starting date.

owner) who has not reached the age of majority. In the case of a child who has not reached the age of majority, calculation of the minimum required distribution under this exception is only allowed through the year that the child reaches the age of majority.

Further, under the provision, the 10-year rule also applies after the death of an eligible beneficiary or after a child reaches the age of majority. Thus, for example, if a disabled child of an employee (or IRA owner) is an eligible beneficiary of a parent who dies when the child is age 20 and the child dies at age 30, even though 52.1 years remain in measurement period,<sup>340</sup> the disabled child's remaining beneficiary interest must be distributed by the end of the tenth year following the death of the disabled child. If a child is an eligible beneficiary based on having not reached the age of majority before the employee's (or IRA owner's) death, the 10-year rule applies beginning with the earlier of the date of the child's death or the date that the child reaches the age of majority. The child's entire interest must be distributed by the end of the tenth year following that date.

As under present law, if the surviving spouse is the beneficiary, a special rule allows the commencement of distribution to be delayed until end of the year that the employee (or IRA owner) would have attained age 70½. If the spouse dies before distributions were required to begin to the spouse, the surviving spouse is treated as the employee (or IRA owner) in determining the required distributions to beneficiaries of the surviving spouse.<sup>341</sup>

#### *Definitions of Disabled and Chronically Ill Individual*

Under the provision, disabled means unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to end in death or to be for long-continued and indefinite duration.<sup>342</sup> Further, under the definition, an individual is not considered to be disabled unless proof of the disability is furnished in such form and manner as the Secretary may require. Substantial gainful activity for this purpose is the activity, or a comparable activity, in which the individual customarily engaged prior

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<sup>340</sup> The measurement period is the life expectancy of the child calculated for the child's age in the year after the employee's (or IRA owner's) death (age 21 (20 plus 1)).

<sup>341</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, pp. 90-91.

<sup>342</sup> The definition of disabled in IRC section 72(m)(7) is incorporated by reference.

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to the arising of the disability (or prior to retirement if the individual was retired at the time the disability arose).<sup>343</sup>

Under the provision, the definition of a chronically ill individual for purposes of qualified long-term care insurance<sup>344</sup> is incorporated by reference with a modification. Under this definition, a chronically ill individual is any individual who (1) is unable to perform (without substantial assistance from another individual) at least two activities of daily living for an indefinite period (expected to be lengthy in nature)<sup>345</sup> due to a loss of functional capacity, (2) has a level of disability similar (as determined under regulations prescribed by the Secretary in consultation with the Secretary of Health and Human Services) to the level of disability described above requiring assistance with daily living based on loss of functional capacity, or (3) requires substantial supervision to protect the individual from threats to health and safety due to severe cognitive impairment. The activities of daily living for which assistance is needed for purposes of determining loss of functional capacity are eating, toileting, transferring, bathing, dressing, and continence.<sup>346</sup>

#### *Annuity Payments under Commercial Annuities*

The provision applies to after-death required minimum distributions under defined contribution plans and IRAs, including annuity contracts purchased from insurance companies under defined contribution plans or IRAs.<sup>347</sup>

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<sup>343</sup> Treas. Reg. section 1.72-17(f). Under the regulations, in determining whether an individual is disabled, primary consideration is given to the nature and severity of the individual's impairment. However, consideration is also given to other factors such as the individual's education, training, and work experience. Whether an impairment in a particular case constitutes a disability is determined with reference to all the facts in the case.

<sup>344</sup> IRC section 7702B(c)(2).

<sup>345</sup> IRC section 7702B(c) only requires this period to be at least 90 days.

<sup>346</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, pp. 91-92.

<sup>347</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, p. 92.

## Effective Dates

The Joint Committee on Taxation report for PL 116-94 states:<sup>348</sup>

### General Effective Date

In determining required minimum distributions after the death of an employee (or IRA owner), the provision is generally effective for required minimum distributions with respect to employees (or IRA owners) with a date of death after December 31, 2019.

### Delayed Effective Date for Governmental and Collectively Bargained Plans

In the case of a governmental plan (as defined in section 414(d)), in determining required minimum distributions after the death of an employee, the provision applies to distributions with respect to employees who die after December 31, 2021.

In the case of a collectively bargained plan,<sup>349</sup> in determining required minimum distributions after the death of an employee, the provision applies to distributions with respect to employees who die in calendar years beginning after the earlier of two dates. The first date is the later of (1) the date on which the last collective bargaining agreement ratified before date of enactment of the provision terminates,<sup>350</sup> or (2) December 31, 2019. The second date is December 31, 2021.

### 10-year Rule after the Death of a Beneficiary

In the case of an employee (or IRA owner) who dies before the effective date (as described below) for the plan (or IRA), if the designated beneficiary of the employee (or IRA owner) dies on or after the effective date, the provision applies to any beneficiary of the designated beneficiary as though the designated beneficiary were an eligible beneficiary. Thus, the entire interest must be distributed by the end of the tenth calendar year after the death of the designated beneficiary. For this purpose, the effective date is the date of

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<sup>348</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, pp. 92-94.

<sup>349</sup> A collectively bargained plan is a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers.

<sup>350</sup> The date that the last agreement terminates is determined without regard to any extension thereof agreed to on or after the date of enactment of the [provision.] Further, any plan amendment made pursuant to a collective bargaining agreement relating to the plan that amends the plan solely to conform to any requirement added by the provision shall not be treated as a termination of the collective bargaining agreement.

death of the employee (or IRA owner) used to determine when the provision applies to the plan (or IRA), for example, before January 1, 2020, under the general effective date.

#### Certain Annuities Grandfathered

The modification to the after-death minimum distribution rules does not apply to a qualified annuity that is a binding annuity contract in effect on the date of enactment of the provision and at all times thereafter. A qualified annuity with respect to an individual is a commercial annuity,<sup>351</sup> under which the annuity payments are made over the lives of the individual and a designated beneficiary (or over a period not extending beyond the life expectancy of the individual or the life expectancy of the individual and a designated beneficiary) in accordance with the required minimum distribution regulations for annuity payments as in effect before enactment of this provision. In addition to these requirements, annuity payments to the individual must begin before the date of enactment, and the individual must have made an irrevocable election before that date as to the method and amount of the annuity payments to the individual or any designated beneficiaries. Alternatively, if an annuity is not a qualified annuity solely based on annuity payments not having begun irrevocably before the date of enactment, an annuity can be a qualified annuity if the individual has made an irrevocable election before the date of enactment as to the method and amount of the annuity payments to the individual or any designated beneficiaries.

#### Plan Amendments Made Pursuant to the Provision

A plan amendment made pursuant to the enacted provision (or regulations issued thereunder) may be retroactively effective and (except as provided by the Secretary) will not violate the anti-cut-back rule, if, in addition to meeting the other applicable requirements described below, the amendment is made on or before the last day of the first plan year beginning after December 31, 2021 (or in the case of a governmental or collectively bargained plan, December 31, 2023), or a later date prescribed by the Secretary. In addition, the plan will be treated as operated in accordance with plan terms during the period beginning with the date that the provision or regulations take effect (or the date specified by the plan if the amendment is not required by the provision or regulations) and ending on the last permissible date for the amendment (or, if earlier, the date the amendment is adopted).

A plan amendment will not be considered to be pursuant to the provision (or applicable regulations) if it has an effective date before the effective date of

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<sup>351</sup> For this purpose, commercial annuity is defined in section 3405(e)(6).



the provision (or regulations) to which it relates. Similarly, the provision does not provide relief from the anti-cut-back rule for periods prior to the effective date of the relevant portion of the provision (or regulations) or the plan amendment. In order for an amendment to be retroactively effective and not violate the anti-cut-back rule, the plan amendment must apply retroactively for the period described in the preceding paragraph, and the plan must be operated in accordance with the amendment during that period.

#### California Law (R&TC sections 17501 and 24601)

California's PITL and CTL generally conform by reference to the federal rules related to the modifications of required minimum distribution rules for designated beneficiaries under IRC sections 401-424 as of the "specified date" of January 1, 2015.<sup>352</sup> However, both the PITL and CTL additionally provide that federal changes to IRC these sections apply without regard to taxable year to the same extent as applicable for federal income tax purposes. In other words, both the PITL and CTL automatically conform to these federal changes. As a result, these modifications automatically apply under California law.

#### Impact on California Revenue

Baseline.

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<u>Section</u>	<u>Section Title</u>
402	Increase in Penalty for Failure to File

#### Background

Under present law, a taxpayer who fails to file a tax return on a timely basis is subject to a penalty equal to five percent of the net amount of tax due for each month that the return is not filed, up to a maximum of five months or 25 percent.<sup>353</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.

In the case of a failure to file a tax return within 60 days of the due date, present law imposes a minimum penalty equal to the lesser of \$330 (indexed annually by an

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<sup>352</sup> R&TC sections 17024.5 and 17501.

<sup>353</sup> IRC section 6651(a)(1).



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inflation adjustment) or 100 percent of the amount of tax required to be shown on the return.

New Federal Law (IRC section 6651)

This provision increased the base minimum tax penalty, for failure to file a tax return within 60 days of the due date, including the extension from \$330 to \$435 for returns required to be filed on or after January 1, 2020.

Effective Date

The provision applies to returns with filing due dates, including extensions, after December 31, 2019.

California Law (R&TC section 19131)

California does not conform by reference to IRC section 6651, relating to failure to file tax return or to pay tax, but instead has standalone language that parallels the federal provision.<sup>354</sup> 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>355</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>356</sup>

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
403	Increased Penalties for Failure to File Retirement Plan Returns

Background

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>357</sup>

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<sup>354</sup> See R&TC section 19131.

<sup>355</sup> R&TC section 19131(a).

<sup>356</sup> R&TC section 19131(c).

<sup>357</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, pp. 97-98.

## Form 5500

An employer that maintains a pension, annuity, stock bonus, profit-sharing or other funded deferred compensation plan (or the plan administrator of the plan) is required to file an annual return containing information required under regulations with respect to the qualification, financial condition, and operation of the plan.<sup>358</sup> The plan administrator of a defined benefit plan subject to the minimum funding requirements<sup>359</sup> is required to file an annual actuarial report.<sup>360</sup> These filing requirements are met by filing an Annual Return/Report of Employee Benefit Plan, Form 5500 series, and providing the information as required on the form and related instructions.<sup>361</sup> A failure to file Form 5500 generally results in a civil penalty of \$25 for each day during which the failure continues, subject to a maximum penalty of \$15,000.<sup>362</sup> This penalty may be waived if it is shown that the failure is due to reasonable cause.

## Annual Registration Statement and Notification of Changes

In the case of a plan subject to the vesting requirements under the Employee Retirement Income Security Act of 1974 ('ERISA'), the plan administrator is required to file a registration statement with the IRS with respect to any plan participant who (1) separated from service during the year and (2) has a vested benefit under the plan, but who was not paid the benefit during the year (a 'deferred vested' benefit).<sup>363</sup> The registration statement must include the name of the plan, the name and address of the plan administrator, the name and taxpayer identification number of the separated participant, and the nature, amount, and form of the participant's deferred vested benefit. A failure to file a registration statement as required generally results in a civil penalty of \$1 for each participant with respect to whom the failure applies, multiplied by the number of days during which the failure continues, subject to a maximum penalty of \$5,000 for a failure with respect to any plan year.<sup>364</sup>

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<sup>358</sup> IRC section 6058.

<sup>359</sup> IRC section 412. Most governmental plans (defined in section 414(d)) and church plans (defined in section 414(e)) are exempt from the minimum funding requirements.

<sup>360</sup> IRC section 6059.

<sup>361</sup> Treas. Reg. sections 301.6058-1(a) and 301.6059-1.

<sup>362</sup> IRC section 6652(e). The failure to file penalties in section 6652 generally apply to certain information returns, including retirement plan returns. The failure to file penalties in section 6651(a)(1), discussed above in section 502 of the bill, generally apply to income, estate, gift, employment and self-employment, and certain excise tax returns.

<sup>363</sup> IRC section 6057(a). Under IRC section 6057(e) and ERISA section 105(c), similar information must be provided to the separated participant.

<sup>364</sup> IRC section 6652(d)(1).

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This penalty may be waived if it is shown that the failure is due to reasonable cause.

A plan administrator is also required to notify the IRS if certain information in a registration changes, specifically, any change in the name of the plan or in the name or address of the plan administrator, the termination of the plan, or the merger or consolidation of the plan with any other plan or its division into two or more plans. A failure to file a required notification of change generally results in a penalty of \$1 for each day during which the failure continues, subject to a maximum penalty of \$1,000 for any failure.<sup>365</sup> This penalty may be waived if it is shown that the failure is due to reasonable cause.

### Withholding Notices

Withholding requirements apply to distributions from tax-favored employer-sponsored retirement plans and IRAs, but, except in the case of certain distributions, payees may generally elect not to have withholding apply.<sup>366</sup> A plan administrator or IRA custodian is required to provide payees with notices of the right to elect no withholding. A failure to provide a required notice generally results in a civil penalty of \$10 for each failure, subject to a maximum penalty of \$5,000 for all failures during any calendar year.<sup>367</sup> This penalty may be waived if it is shown that the failure is due to reasonable cause and not to willful neglect.

### New Federal Law (IRC section 6652)

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>368</sup>

#### Form 5500

Under the provision, a failure to file Form 5500 generally results in a penalty of \$105 for each day during which the failure continues, subject to a maximum but the total amount imposed under this subsection on any person for failure to file any return shall not exceed \$50,000.

#### Annual Registration Statement and Notification of Changes

Under the provision, a failure to file a registration statement as required generally results in a penalty of \$2 for each participant with respect to whom

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<sup>365</sup> IRC section 6652(d)(2).

<sup>366</sup> IRC section 3405.

<sup>367</sup> IRC section 6652(h).

<sup>368</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, pages 98, 99.

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the failure applies, multiplied by the number of days during which the failure continues, subject to a maximum penalty of \$10,000 for a failure with respect to any plan year. A failure to file a required notification of change generally results in a penalty of \$2 for each day during which the failure continues, subject to a maximum penalty of \$5,000 for any failure.

#### Withholding Notices

Under the provision, a failure to provide a required withholding notice generally results in a penalty of \$100 for each failure, subject to a maximum penalty of \$50,000 for all failures during any calendar year.

#### Effective Date

The provision is effective for returns, statements and notifications required to be filed, and withholding notices to be provided, after December 31, 2019.

#### California Law (None)

California does not conform to IRC section 6652 penalties for failure to file retirement plan returns.

#### Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
404	Increase Information Sharing to Administer Excise Taxes

#### Background

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>369</sup>

Generally, tax returns and return information ('tax information') are confidential and may not be disclosed unless authorized in the IRC. Return information includes data received, collected or prepared by the Secretary with respect to the determination of the existence or possible existence of liability of any person under the IRC for any tax, penalty, interest, fine, forfeiture, or other imposition or offense. Criminal penalties apply for the unauthorized inspection or disclosure of tax information. Willful unauthorized disclosure is a felony under

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<sup>369</sup> Joint Committee on Taxation, Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1994, the "Setting Every Community Up for Retirement Enhancement (Secure) Act of 2019," JCX-13-19, P.L. 116-94, 116th Congress (2019-2020), December 20, 2020, page 100.

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IRC section 7213 and the willful unauthorized inspection of tax information is a misdemeanor under IRC section 7213A. Taxpayers may also pursue a civil cause of action for disclosures and inspections not authorized by IRC section 6103.

IRC section 6103 provides exceptions to the general rule of confidentiality, detailing permissible disclosures. Under IRC section 6103(h)(1), tax information is open to inspection by or disclosure to Treasury officers and employees whose official duties require the inspection or disclosure for tax administration purposes.

The heavy vehicle use tax, an annual highway use tax, is imposed on the use of any highway motor vehicle that has a gross weight of 55,000 pounds or more. Proof of payment of the heavy vehicle use tax must be presented to customs officials upon entry into the U.S. of any highway motor vehicle subject to the tax and that has a base in a contiguous foreign country. If the operator of the vehicle is unable to present proof of payment of the tax with respect to the vehicle, entry into the U.S. may be denied.

Prior to 2003, customs officials who had responsibility for enforcing and/or collecting excise taxes were employees of the U.S. Department of the Treasury (Treasury). Thus, prior to 2003, IRC section 6103(h)(1) allowed disclosure of tax information by the IRS to these customs officials in the performance of their duties. In 2003, U.S. Customs and Border Protection became an official agency of the U.S. Department of Homeland Security. At that time, customs officials were transferred from Treasury to the U.S. Department of Homeland Security.

New Federal Law (IRC section 6103)

“The provision allows the IRS to share returns and return information with employees of U.S. Customs and Border Protection whose official duties require such inspection or disclosure for purposes of administering and collecting the heavy vehicle use tax.”

Effective Date

The provision is effective December 20, 2019.

California Law (None)

Although California has standalone disclosure of information rules, California does not conform to IRC section 6103, related to information sharing for purposes of administering the heavy vehicle use tax.

Impact on California Revenue

Not applicable.

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Title V — Tax Relief for Certain Children

<u>Section</u>	<u>Section Title</u>
501	Modification of Rules Relating to the Taxation of Unearned Income of Certain Children

Background

Unearned Income of Children

Special rules (generally referred to as the “kiddie tax”) apply to the net unearned income of certain children.<sup>370</sup> Generally, the kiddie tax applies to a child if: (1) the child has not reached the age of 19 by the close of the taxable year, or the child is a full-time student under the age of 24, and either of the child’s parents is alive at such time; (2) the child’s unearned income exceeds \$2,200 (for 2019); and (3) the child does not file a joint return.<sup>371</sup> The kiddie tax applies regardless of whether the child may be claimed as a dependent by either or both parents. For children above age 17, the kiddie tax applies only to children whose earned income does not exceed one-half of the amount of their support.

Under these rules, for taxable years prior to January 1, 2018, the net unearned income of a child (for 2019, unearned income over \$2,200) is taxed at the parents’ tax rates if the parents’ tax rates are higher than the tax rates of the child.<sup>372</sup> The remainder of a child’s taxable income (i.e., earned income, plus unearned income up to \$2,200 (for 2019), less the child’s standard deduction) is taxed at the child’s rates, regardless of whether the kiddie tax applies to the child. Under the Tax Cuts and Jobs Act (TCJA, P.L. 115-97, 12/22/2017), for taxable years beginning after December 31, 2017, net unearned income of a child was taxed according to the brackets applicable to trust and estates.

For these purposes, unearned income is income other than wages, salaries, professional fees, other amounts received as compensation for personal services actually rendered, and distributions from qualified disability trusts.<sup>373</sup> In general, a

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<sup>370</sup> IRC section 1(g).

<sup>371</sup> IRC section 1(g)(2).

<sup>372</sup> Special rules apply for determining which parent’s rate applies where a joint return is not filed.

<sup>373</sup> IRC sections 1(g)(4) and 911(e)(2).

child is eligible to use the preferential tax rates for qualified dividends and capital gains.<sup>374</sup>

The kiddie tax is calculated by computing the “allocable parental tax.” This involves adding the net unearned income of the child to the parent’s income and then applying the parent’s tax rate. A child’s “net unearned income” is the child’s unearned income less the sum of (1) the minimum standard deduction allowed to dependents), and (2) the greater of (a) such minimum standard deduction amount or (b) the amount of allowable itemized deductions that are directly connected with the production of the unearned income.<sup>375</sup>

The allocable parental tax equals the hypothetical increase in tax to the parent that results from adding the child’s net unearned income to the parent’s taxable income.<sup>376</sup> If the child has net capital gains or qualified dividends, these items are allocated to the parent’s hypothetical taxable income according to the ratio of net unearned income to the child’s total unearned income. If a parent has more than one child subject to the kiddie tax, the net unearned income of all children is combined, and a single kiddie tax is calculated. Each child is then allocated a proportionate share of the hypothetical increase, based upon the child’s net unearned income relative to the aggregate net unearned income of all of the parent’s children subject to the tax.

Generally, a child must file a separate return to report his or her income.<sup>377</sup> In such case, items on the parents’ return are not affected by the child’s income, and the total tax due from the child is the greater of:

- The sum of (a) the tax payable by the child on the child’s earned income and unearned income up to \$2,200 (for 2019), plus (b) the allocable parental tax on the child’s unearned income, or
- The tax on the child’s income without regard to the kiddie tax provisions.<sup>378</sup>

Under certain circumstances, a parent may elect to report a child’s unearned income on the parent’s return.<sup>379</sup>

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<sup>374</sup> IRC section 1(h).

<sup>375</sup> IRC section 1(g)(4).

<sup>376</sup> IRC section 1(g)(3).

<sup>377</sup> IRC section 1(g)(6). See Form 8615, Tax for Certain Children Who Have Unearned Income.

<sup>378</sup> IRC section 1(g)(1).

<sup>379</sup> IRC section 1(g)(7).



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Coordination with Alternative Minimum Tax (AMT)

The unearned income of a child subject to the kiddie tax may be subject to AMT. All regular AMT preferences and adjustments apply to the child's unearned income and, in addition, the child's exemption amount is limited.

New Federal Law (IRC sections 1 and 55)

Tax on Unearned Income of Children

This Act repeals the kiddie tax provisions added by the TCJA. Therefore, the unearned income of children is taxed under the pre-TCJA laws, as explained above.

Coordination with AMT

The provision eliminates the reduced AMT exemption amount related to treatment of unearned income of minor children.

Effective Dates

Tax on Unearned Income of Children

The provision applies to taxable years beginning on or after December 31, 2019. However, taxpayers can elect retroactive application to tax years beginning in 2018, 2019, or both.

Coordination with AMT

The amendments to IRC section 55(d)(4)(A) applies to taxable years beginning after December 31, 2017.

California Law (R&TC sections 17041 and 17062)

Tax on Unearned Income of Children

California conforms, under the PITL, to IRC section 1(g), relating to the tax on unearned income of children as of the "specified date" of January 1, 2015,<sup>380</sup> with modifications.

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<sup>380</sup> R&TC section 17024.5.

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Coordination with AMT

For taxable years beginning on or after January 1, 2015, R&TC section 17062 conforms to the federal calculation of tentative minimum tax as provided by IRC sections 55 to 59, as of the “specified date” of January 1, 2015, with modifications.

Impact on California Revenue

Tax on Unearned Income of Children

Baseline.

Coordination with AMT

Estimated Conformity Revenue Impact of Modification of Rules Relating to the Taxation of Unearned Income of Certain Children Coordination with AMT

For Taxable Years Beginning On or After January 1, 2020  
Enactment Assumed After June 30, 2020

2019-2020	2020-2021	2021-2022	2022-2023
N/A	-\$80,000	-\$50,000	-\$60,000

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Division Q — Revenue Provisions  
Title I — Extension of Certain Expiring Provisions  
Subtitle A — Tax Relief and Support for Families and Individuals

<u>Section</u>	<u>Section Title</u>
101	Exclusion from Gross Income of Discharge of Qualified Principal Residence Indebtedness

Background

In General

Gross income includes income that is realized by a debtor from the discharge of indebtedness, subject to certain exceptions for debtors in Title 11 bankruptcy cases, insolvent debtors, certain student loans, certain farm indebtedness, and certain real

property business indebtedness.<sup>381</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>382</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 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

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<sup>381</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>382</sup> IRC section 1017.

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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, 2018.

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, 2018, if the discharge was pursuant to a binding written agreement entered into prior to January 1, 2018.

New Federal Law (IRC section 108)

The provision extends for three additional years, before January 1, 2021, 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, 2021, if the discharge was pursuant to a binding written agreement entered into prior to January 1, 2021.

The provision also clarifies that the temporary reduction of the acquisition indebtedness limitation from \$1,000,000 (\$500,000 in the case of a married individual filing a separate return) to \$750,000 (\$375,000 in the case of a married individual filing a separate return)<sup>383</sup> does not apply with regard to the \$2,000,000 limitation on acquisition indebtedness for purposes of the discharge of qualified principal residence indebtedness.<sup>384</sup>

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<sup>383</sup> IRC section 163(h)(3)(F)(i)(II), relating to taxable years beginning after December 31, 2017, and before January 1, 2026.

<sup>384</sup> IRC section 108(h)(2).

## Effective Date

The provision applies for discharges of indebtedness after December 31, 2017.

## 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>385</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>386</sup> as of the specified date of January 1, 2015,<sup>387</sup> with the modifications described below:

1. The exclusion does not apply to discharges occurring after 2013.
  - a. The California exclusion applies to discharges occurring on or after January 1, 2007, and before January 1, 2014.
  - b. The federal exclusion generally applies to discharges occurring on or after January 1, 2007, and before January 1, 2021.<sup>388</sup>
2. The maximum amount of qualified principal residence indebtedness (i.e., the amount of principal residence indebtedness eligible for the exclusion) is reduced.
  - a. 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).
  - b. 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).
3. The total amount that may be excluded from gross income is limited.
  - a. 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).
  - b. 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).

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<sup>385</sup> R&TC sections 17071 and 17131.

<sup>386</sup> R&TC section 17144.5.

<sup>387</sup> R&TC section 17024.5.

<sup>388</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, 2021, if the discharge was pursuant to a binding written agreement entered into prior to January 1, 2021.

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- c. There is no comparable federal limitation in any year.
- 4. Interest and penalties are not imposed with respect to 2007, 2009, or 2013 discharges.
  - a. 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.
  - b. There is no comparable federal prohibition.

Impact on California Revenue

Estimated Conformity Revenue Impact of Exclusion from Gross Income of Discharge of Qualified Principal Residence Indebtedness

For Taxable Years Beginning On or After January 1, 2020  
Enactment Assumed After June 30, 2020

2019-2020	2020-2021	2021-2022	2022-2023
N/A	-\$25,000,000	-\$2,000,000	N/A

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<u>Section</u>	<u>Section Title</u>
102	Treatment of Mortgage Insurance Premiums 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>389</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. 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

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<sup>389</sup> IRC section 163(h).

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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.<sup>390</sup>

For taxable years beginning after December 31, 2017, and beginning before January 1, 2026, a taxpayer may treat no more than \$750,000 as acquisition indebtedness (\$375,000 in the case of married taxpayers filing separately). In the case of acquisition indebtedness incurred before December 15, 2017,<sup>391</sup> this limitation is \$1,000,000 (\$500,000 in the case of married taxpayers filing separately).<sup>392</sup> For taxable years beginning after December 31, 2025, a taxpayer may treat up to \$1,000,000 (\$500,000 in the case of married taxpayers filing separately) of indebtedness as acquisition indebtedness, regardless of when the indebtedness was incurred.

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

### 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 (\$500 and \$50,000, respectively, in the case of a married individual filing a separate return). Thus, the deduction is not allowed if the taxpayer's AGI exceeds \$109,000 (\$54,500 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

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<sup>390</sup> IRC section 163(h)(4).

<sup>391</sup> The provision specifies that a taxpayer who has entered into a binding written contract before December 15, 2017, to close on the purchase of a principal residence before January 1, 2018, and who purchases such residence before April 1, 2018, shall be considered to have incurred acquisition indebtedness prior to December 15, 2017.

<sup>392</sup> Special rules apply in the case of indebtedness from refinancing existing acquisition indebtedness. Specifically, the \$1,000,000 (\$500,000 in the case of married taxpayers filing separately) limitation continues to apply to any indebtedness incurred on or after December 15, 2017, to refinance qualified residence indebtedness incurred before that date to the extent the amount of the indebtedness resulting from the refinancing does not exceed the amount of the refinanced indebtedness. Thus, the maximum dollar amount that may be treated as principal residence acquisition indebtedness will not decrease by reason of a refinancing.



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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, 2017, 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 three years (with respect to contracts entered into after December 31, 2017). Thus, the provision applies to amounts paid or accrued after December 31, 2017, and on or before December 31, 2020, (and not properly allocable to any period after 2020).

Effective Date

The provision applies to amounts paid or accrued after December 31, 2017.

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>
103	Reduction in Medical Expense Deduction Floor

Background

For taxable years beginning after December 31, 2012, and ending before January 1, 2017, individuals could claim an itemized deduction for unreimbursed medical expenses, but only to the extent that such expenses exceed 10 percent of AGI.<sup>393</sup> For taxable years beginning before January 1, 2017, the 10-percent threshold was reduced to 7.5 percent in the case of taxpayers who have attained the age of 65 before the close of the taxable year. In the case of married taxpayers, the more favorable 7.5-percent threshold applies if either spouse has obtained the age of 65 before the close of the taxable year. For these taxpayers, during these years, in computing alternative minimum taxable income, the threshold is 10 percent for AMT purposes.

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

New Federal Law (IRC sections 56 and 213)

The provision extends the current 7.5 percent of AGI medical expense deduction threshold to taxable years ending before January 1, 2021. The provision also permanently changes the AMT threshold to be the same as for regular tax.

Effective Date

The provision is effective for taxable years beginning on or after December 31, 2018.

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

California conforms, under the PITL, relating to the itemized deduction for unreimbursed medical expenses under IRC section 213, as of the “specified date” of January 1, 2015,<sup>394</sup> with modifications. California’s modified conformity allows a deduction for the amount of medical expenses unreimbursed by insurance that exceed 7.5 percent of federal AGI.<sup>395</sup> As a result, the threshold percentage of unreimbursed medical expenses is the same for both federal and state purposes for

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<sup>393</sup> IRC section 213. The threshold was amended by the Patient Protection and Affordable Care Act (P.L. No. 111-118). For taxable years beginning before January 1, 2013, the threshold was 7.5 percent and 10 percent for AMT purposes.

<sup>394</sup> R&TC section 17024.5.

<sup>395</sup> R&TC sections 17241 and 17024.5(h)(2)(A).

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the 2017 through 2020 tax years for purposes of the personal income tax. However, for taxable years beginning on or after January 1, 2021, the threshold for deducting unreimbursed medical expenses for federal and state taxes will differ – 10 percent of federal AGI for federal taxes and 7.5 percent of federal AGI for state income taxes.

**AMT**

California conforms, under the PITL, relating to the AMT under IRC section 56, as of the “specified date” of January 1, 2015, with modifications.<sup>396</sup> However, California does not conform to the federal change to the AMT medical expense threshold from 10 percent to 7.5 percent of AGI. For California AMT purposes, the unreimbursed medical expense threshold remains 10 percent of federal AGI.<sup>397</sup>

Impact on California Revenue

Estimated Conformity Revenue Impact of Reduction in Medical Expense Deduction Floor  
For Taxable Years Beginning On or After January 1, 2020

Enactment Assumed After June 30, 2020

2019-20	2020-21	2021-22	2022-23
N/A	\$60,000	N/A	N/A

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<u>Section</u>	<u>Section Title</u>
104	Deduction of 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>398</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

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<sup>396</sup> R&TC section 17062.

<sup>397</sup> IRC section 56(b)(1)(B).

<sup>398</sup> IRC section 222.

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education for courses of instruction of such individual at such institution.<sup>399</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, 2017.

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>400</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>401</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 three years, through 2020.

#### Effective Date

The provision is effective for taxable years beginning after December 31, 2017.

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<sup>399</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.

<sup>400</sup> IRC sections 222(d)(1) and 25A(g)(2).

<sup>401</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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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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<u>Section</u>	<u>Section Title</u>
105	Black Lung Disability Trust Fund Excise Tax

Background

A \$1.10 per ton excise tax is imposed on coal sold by the producer from underground mines in the U.S. The rate is 55 cents per ton on coal sold by the producer from surface mining operations. In either case, the tax cannot exceed 4.4 percent of the coal producer's selling price. No tax is imposed on lignite.

Gross receipts from the excise tax are dedicated to the Black Lung Disability Trust Fund (BLDTF) to finance benefits under the Federal Black Lung Benefits Act. Currently, the BLDTF is in a deficit position because previous spending was financed with interest-bearing advances from the General Fund.

The coal excise tax rates on coal continue at the above rates until the earlier of the following dates: (1) January 1, 2019, and (2) the day after the first December 31 after 2007 on which the BLDTF has repaid, with interest, all amounts borrowed from the General Fund. On and after that date, the reduced rates of \$.50 per ton for coal from underground mines and \$.25 per ton for coal from surface mines will apply and the tax per ton of coal will be capped at two percent of the amount for which it is sold by the producer.

New Federal Law (IRC section 4121)

The provision retains the excise tax on coal at the current rates until the earlier of the following dates: (1) January 1, 2021, and (2) the day after the first December 31 after 2007 on which the BLDTF has repaid, with interest, all amounts borrowed from the General Fund. On and after that date, the reduced rates of \$.50 per ton for coal from underground mines and \$.25 per ton for coal from surface mines will apply and

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the tax per ton of coal will be capped at two percent of the amount for which it is sold by the producer.

Effective Date

The provision applies on or after the first day of the first calendar month beginning after December 20, 2019.

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 B — Incentives for Employment, Economic Growth  
and Community Development

<u>Section</u>	<u>Section Title</u>
111	Indian Employment Credit

Background

In general, a credit 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>402</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.

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<sup>402</sup> IRC section 45A.

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An “Indian reservation” is a reservation as defined in section 3(d) of the Indian Financing Act of 1974<sup>403</sup> or section 4(10) of the Indian Child Welfare Act of 1978.<sup>404</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 (after adjustment for inflation is \$50,000 for 2018, 2019, and 2020.)<sup>405</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, 2017.

New Federal Law (IRC section 45A)

The provision extends the Indian employment credit for three years through taxable years beginning on or before December 31, 2020.

Effective Date

The provision is effective for taxable years beginning after December 31, 2017.

California Law (None)

California does not conform to the Indian Employment Tax Credit.

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<sup>403</sup> P.L. 93-262.

<sup>404</sup> P.L. 95-608.

<sup>405</sup> See Instructions for Form 8845, Indian Employment Credit (January 30, 2020).



Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
112	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, 2018.<sup>406</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>407</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>408</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>409</sup>

Qualified railroad track maintenance expenditures are defined as gross expenditures (whether or not otherwise chargeable to capital account) for maintaining railroad track (including roadbed, bridges, and related track structures) owned or leased as of January 1, 2005, by a Class II or Class III railroad (determined without regard to any consideration for such expenditure given by the Class II or Class III railroad which made the assignment of such track).<sup>410</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>411</sup>

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<sup>406</sup> IRC sections 45G(a) and (f).

<sup>407</sup> IRC section 45G(b)(1).

<sup>408</sup> IRC section 38(c)(4).

<sup>409</sup> IRC section 45G(e)(3).

<sup>410</sup> IRC section 45G(d).

<sup>411</sup> IRC section 45G(c).

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The terms Class II or Class III railroad have the meanings given by the Surface Transportation Board.<sup>412</sup>

Qualified railroad track maintenance expenditures paid or incurred in taxable years beginning after December 31, 2017, 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 credit for five years, for qualified railroad track maintenance expenditures paid or incurred in taxable years beginning after December 31, 2018, and before January 1, 2023.

The provision also specifies that any assignment of railroad track, including related expenditures paid or incurred, for taxable years ending after January 1, 2018, and before January 1, 2020, 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 December 20, 2019, the date of enactment.

Effective Dates

The provision is effective for expenditures paid or incurred in taxable years beginning after December 31, 2017.

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.

Impact on California Revenue

Not applicable.

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<sup>412</sup> IRC section 45G(e)(1).

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<u>Section</u>	<u>Section Title</u>
113	Mine Rescue Team Training Credit

Background

An eligible employer may claim a general business credit against income tax with respect to each qualified mine rescue team employee equal to the lesser of: (1) 20 percent of the amount paid or incurred by the taxpayer during the taxable year with respect to the training program costs of the qualified mine rescue team employee (including the wages of the employee while attending the program); or (2) \$10,000.<sup>413</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>414</sup>

An eligible employer is any taxpayer which employs individuals as miners in underground mines in the U.S.<sup>415</sup>

The credit does not apply to taxable years beginning after December 31, 2017.<sup>416</sup>

New Federal Law (IRC section 45N)

The provision extends the termination date of the credit for three taxable years, allowing the credit for taxable years beginning before December 31, 2020, rather than the termination date of the credit for taxable years beginning after December 31, 2017.

Effective Date

The provision is effective for taxable years beginning after December 31, 2017.

California Law (None)

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

Impact on California Revenue

Not applicable.

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<sup>413</sup> IRC section 45N(a).

<sup>414</sup> IRC section 45N(b).

<sup>415</sup> IRC section 45N(c).

<sup>416</sup> IRC section 45N(e).

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<u>Section</u>	<u>Section Title</u>
114	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>417</sup> Tangible property generally is depreciated under the modified accelerated cost recovery system (MACRS), which determines depreciation by applying specific recovery periods,<sup>418</sup> placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.<sup>419</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>420</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>421</sup> A seven-year recovery period was 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>422</sup>

MACRS was extended to allow a three-year recovery period for race horses for one year to apply to any race horse (regardless of age when placed in service), which was placed in service before January 1, 2018. The three-year recovery period will only apply for race horses that were more than two years old when placed in service by the purchaser after December 31, 2017.

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<sup>417</sup> See IRC sections 263(a) and 167.

<sup>418</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 Rev. Proc. 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 Rev. Proc. 88-22 (1988-1 C.B. 785). In November 1988, Congress revoked the Secretary's authority to modify the class lives of depreciable property. Rev. Proc. 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>419</sup> IRC section 168.

<sup>420</sup> IRC section 168(e)(3)(A)(i)(I), as in effect after amendment by the Food, Conservation and Energy Act of 2008, P.L. 110-246, section 15344(b).

<sup>421</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. Rev. Proc. 87-56, 1987-2 C.B. 674, as clarified and modified by Rev. Proc. 88-22, 1988-1 C.B. 785.

<sup>422</sup> Rev. Proc. 87-56, 1987-2 C.B. 674, asset class 01.225.

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New Federal Law (IRC section 168(e))

The provision extends the three-year recovery period for race horses for three years to apply to any race horse (regardless of age when placed in service), which is placed in service before January 1, 2021. 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, 2020.

Effective Date

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

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>423</sup> with modifications.<sup>424</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 race horses that was enacted in the Consolidated Appropriations Act, 2016,<sup>425</sup> and the additional one-year extension that was enacted in the Bipartisan Budget Act of 2018<sup>426</sup>; instead, for race horses placed in service after December 31, 2013, a three-year recovery period is assigned to any race horse 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 rules, which generally allow property to be depreciated based on its useful life.<sup>427</sup>

Impact on California Revenue

Not applicable.

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<sup>423</sup> R&TC section 17201 conforms to IRC section 168 as of the specified date of January 1, 2015, except as otherwise provided.

<sup>424</sup> R&TC section 17250.

<sup>425</sup> Section 165 of P.L. 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>426</sup> P.L. 115-123, February 9, 2018.

<sup>427</sup> R&TC sections 24349-24355.4.

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<u>Section</u>	<u>Section Title</u>
115	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>428</sup> Tangible property generally is depreciated under MACRS, which determines depreciation by applying specific recovery periods,<sup>429</sup> placed-in-service conventions, and depreciation methods to the cost of various types of depreciable property.<sup>430</sup> The cost of nonresidential real property is recovered using the straight-line method of depreciation and a recovery period of 39 years.<sup>431</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>432</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>433</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>434</sup>

An exception exists for the theme and amusement park industry, whose assets are assigned a recovery period of seven years.<sup>435</sup> Additionally, a motorsports

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<sup>428</sup> See IRC sections 263(a) and 167.

<sup>429</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 Rev. Proc. 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 Rev. Proc. 88-22 (1988-1 C.B. 785). In November 1988, Congress revoked the Secretary's authority to modify the class lives of depreciable property. Rev. Proc. 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>430</sup> IRC section 168.

<sup>431</sup> IRC sections 168(b)(3)(A) and (c).

<sup>432</sup> IRC sections 168(d)(2)(A) and (d)(4)(B).

<sup>433</sup> IRC sections 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 sections 168(d)(3) and (d)(4)(C).

<sup>434</sup> IRC section 168(b)(2)(A) and asset class 00.3 of Rev. Proc. 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 sections 168(b)(2) and (b)(1)(B).

<sup>435</sup> Asset class 80.0 of Rev. Proc. 87-56, 1987-2 C.B. 674.

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entertainment complex placed in service on or before December 31, 2017,<sup>436</sup> is assigned a recovery period of seven years.<sup>437</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 following its placed-in-service date hosts a racing event.<sup>438</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(i))

The provision extends the seven-year recovery period for a motorsports entertainment complex for three years to apply to property placed in service on or before December 31, 2020.

Effective Date

The provision is effective for property placed in service after December 31, 2017.

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>439</sup> but specifically does not conform to the seven-year recovery period for property placed in service on or after January 1, 2008.<sup>440</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>441</sup>

The CTL temporarily adopted the seven-year recovery period for motorsports entertainment complexes, for property placed in service on or after

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<sup>436</sup> IRC section 168(i)(15)(D).

<sup>437</sup> IRC section 168(e)(3)(C)(ii).

<sup>438</sup> IRC section 168(i)(15).

<sup>439</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 R&TC 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>440</sup> R&TC section 17250(a)(11).

<sup>441</sup> R&TC sections 24349-24355.4.



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January 1, 2005, and before December 31, 2007.<sup>442</sup> The seven-year recovery period is not allowed for property placed in service on or after January 1, 2008.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
116	Accelerated Depreciation for Business Property on Indian Reservations

Background

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

Estimated Useful Life Years	Recovery Period
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>443</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>444</sup> and (4) is not property placed in service for purposes of

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<sup>442</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.

<sup>443</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>444</sup> For these purposes, the term “related persons” is defined in IRC section 465(b)(3)(C).

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conducting gaming activities.<sup>445</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>446</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>447</sup> or section 4(10) of the Indian Child Welfare Act of 1978 (25 U.S.C. 1903(10)).<sup>448</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>449</sup>

The depreciation deduction allowed for regular tax purposes is also allowed for purposes of the AMT.<sup>450</sup> The accelerated depreciation for qualified Indian reservation property is available with respect to property placed in service on or before December 31, 2017.<sup>451</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.<sup>452</sup>

New Federal Law (IRC section 168(j)(9))

The provision extends the accelerated depreciation for qualified Indian reservation property for three years for property placed in service on or before December 31, 2020.

Effective Date

The provision is effective for property placed in service after December 31, 2017.

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<sup>445</sup> IRC section 168(j)(4)(A).

<sup>446</sup> IRC section 168(j)(4)(C).

<sup>447</sup> P.L. 93-262.

<sup>448</sup> P.L. 95-608.

<sup>449</sup> IRC section 168(j)(6).

<sup>450</sup> IRC section 168(j)(3).

<sup>451</sup> IRC section 168(j)(9).

<sup>452</sup> IRC section 168(j)(8).

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

This provision is not applicable under California law.

The PITL generally conforms to MACRS, but specifically does not conform to accelerated depreciation for business property on an Indian Reservation.<sup>453</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>454</sup>

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
117	Expensing Rules for Certain Productions

Background

Under IRC section 181, a taxpayer may elect<sup>455</sup> to deduct the cost of any qualifying film or television production or any qualified live theatrical production, commencing prior to January 1, 2018,<sup>456</sup> in the year the expenditure is incurred in lieu of capitalizing the cost and recovering it through depreciation allowances.<sup>457</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>458</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>459</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 U.S. by actors, directors, producers, and other relevant production personnel.<sup>460</sup> The term "compensation" does not include

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<sup>453</sup> R&TC section 17250(a)(3).

<sup>454</sup> R&TC sections 24349-24355.4.

<sup>455</sup> See Treas. Reg. section 1.181-2 for rules on making an election under this section.

<sup>456</sup> IRC section 181(g).

<sup>457</sup> For this purpose, a production is treated as commencing on the first date of principal photography.

<sup>458</sup> IRC section 181(a)(2)(A).

<sup>459</sup> IRC section 181(a)(2)(B).

<sup>460</sup> IRC sections 181(d)(1)-(3)(A).

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participations and residuals (as defined in IRC section 167(g)(7)(B)).<sup>461</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>462</sup>

Qualified productions do not include sexually explicit productions as referenced by section 2257 of title 18 of the U.S.C.<sup>463</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>464</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 taxable 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.<sup>465</sup> 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.<sup>466</sup> In general, in the case of multiple live-staged productions, each such live-staged production is treated as a separate production.<sup>467</sup> 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.C., if such provision were extended to live-stage performances.<sup>468</sup> 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 three years to productions commencing prior to January 1, 2021.

#### Effective Date

The provision applies to productions commencing after December 31, 2017.

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<sup>461</sup> IRC section 181(d)(3)(B).

<sup>462</sup> IRC section 181(d)(2)(B).

<sup>463</sup> IRC section 181(d)(2)(C).

<sup>464</sup> IRC section 1245(a)(2)(C).

<sup>465</sup> IRC section 181(e)(2)(A).

<sup>466</sup> IRC section 181(e)(2)(D).

<sup>467</sup> IRC section 181(e)(2)(B).

<sup>468</sup> IRC section 181(e)(2)(E).

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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 and qualified live theatrical production in the year the expenditure is incurred in lieu of capitalizing the cost and recovering it through depreciation allowances,<sup>469</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, videotapes, television, book rights, patents, master sound recordings, video games, and like items.<sup>470</sup>

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
118	Empowerment Zone Tax Incentives

Background

In General

The Omnibus Budget Reconciliation Act of 1993 (OBRA 93)<sup>471</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>472</sup> designated by the Secretaries of the Department of Housing and Urban Development (HUD) and the U.S. Department of 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

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<sup>469</sup> R&TC section 17201.5.

<sup>470</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>471</sup> P.L. 103-66.

<sup>472</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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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>473</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>474</sup> authorized a total of 10 new empowerment zones (“Round III empowerment zones”), bringing the total number of authorized empowerment zones to 40.<sup>475</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 has extended the empowerment zone incentives through December 31, 2020.<sup>476</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

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<sup>473</sup> P.L. 105-34.

<sup>474</sup> P.L. 106-554.

<sup>475</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>476</sup> P.L. 111-312, section 753 (2010), P.L. 112-240, section 327(a)(2013), P.L. 113-295, section 139 (2014), and P.L. 114-113, Title I, section 171 (2015).



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(2) performs substantially all employment services within the empowerment zone in a trade or business of the employer.<sup>477</sup>

The wage credit rate applies to qualifying wages paid before January 1, 2017.<sup>478</sup> 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).<sup>479</sup> 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.<sup>480</sup> 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>481</sup>

An employer’s deduction otherwise allowed for wages paid is reduced by the amount of wage credit claimed for that taxable year.<sup>482</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>483</sup> In addition, the \$15,000 cap is reduced by any wages taken into account in computing the WOTC.<sup>484</sup> The wage credit may be used to offset up to 25 percent of the employer’s AMT liability.<sup>485</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>486</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

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<sup>477</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>478</sup> IRC section 1397A.

<sup>479</sup> IRC section 1396 (c)(2).

<sup>480</sup> IRC section 1396(d)(2).

<sup>481</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>482</sup> IRC section 280C(a).

<sup>483</sup> IRC section 1396(c)(3)(A).

<sup>484</sup> IRC section 1396(c)(3)(B).

<sup>485</sup> IRC section 38(c)(2).

<sup>486</sup> IRC section 1397A.

year).<sup>487</sup> 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>488</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>489</sup>

The term “qualified zone property” is defined as depreciable tangible property (including buildings) provided that (i) the property is acquired by the taxpayer (from an unrelated party) after the designation took effect, (ii) the original use of the property in an empowerment zone commences with the taxpayer, and (iii) substantially all of the use of the property is in an empowerment zone in the active conduct of a trade or business by the taxpayer.<sup>490</sup> Special rules are provided in the case of property that is substantially renovated by the taxpayer.<sup>491</sup>

An enterprise zone business means any qualified business entity and any qualified proprietorship.<sup>492</sup> 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>493</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

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<sup>487</sup> See IRC section 179(b)(1) and P.L. 115-97 section 13101(a)(1).

<sup>488</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>489</sup> IRC section 1397A(a)(2).

<sup>490</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>491</sup> IRC section 1397D(a)(2).

<sup>492</sup> IRC sections 1397C(b) and (c).

<sup>493</sup> IRC section 1397C(b).

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>494</sup>

A qualified business is defined as any trade or business other than a trade or business that consists predominantly of the development or holding of intangibles for sale or license or any business prohibited in connection with the employment credit.<sup>495</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.<sup>496</sup>

#### 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. 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.<sup>497</sup>

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

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<sup>494</sup> IRC section 1397C(c).

<sup>495</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>496</sup> IRC sections 1397C(d) and 1397D.

<sup>497</sup> IRC section 1394.

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modifications for start-up businesses.<sup>498</sup> 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>499</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.<sup>500</sup>

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.<sup>501</sup>

#### 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>502</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.<sup>503</sup>

#### 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>504</sup> For stock acquired prior to February 18, 2009, or after December 31, 2014, the percentage is

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<sup>498</sup> IRC sections 1394(b)(3) and 1397C.

<sup>499</sup> IRC section 1394(b)(3).

<sup>500</sup> IRC section 1394(b)(3)(D).

<sup>501</sup> IRC section 1394(f)(2).

<sup>502</sup> IRC section 1397B.

<sup>503</sup> IRC section 1397B(b).

<sup>504</sup> IRC section 1202.

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>505</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, 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

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<sup>505</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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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.<sup>506</sup>

New Federal Law (IRC section 1391)

The provision extends for three years, through December 31, 2020, the period for which the designation of an empowerment zone is in effect, thus extending for three years 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, 2017, 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 applies to taxable years beginning after December 31, 2017.

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 three-year federal extension of empowerment zone designations is not applicable under California law.

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 DGA, 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

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<sup>506</sup> IRC section 1394(b)(3)(C).



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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>507</sup>

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
119	American Samoa Economic Development Credit

Background

A domestic corporation that was an existing credit claimant with respect to American Samoa and that elected the application of IRC section 936 for its last taxable year beginning before January 1, 2006, is allowed a credit based on the corporation's economic activity-based limitation with respect to American Samoa. The credit is not part of the IRC, but is computed based on the rules of IRC sections 30A and 936. The credit is allowed for the first twelve taxable years of a corporation that begin after December 31, 2005, and before January 1, 2018.

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>508</sup> in an election in effect for its taxable year that included

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<sup>507</sup> R&TC sections 17053.73 and 23626.

<sup>508</sup> For taxable years beginning before January 1, 2006, certain domestic corporations with business operations in U.S. possessions were eligible for the possession tax credit. U.S. possessions (as defined by IRC section 936(d)(1)) includes Puerto Rico and the U.S. Virgin Islands, which includes American Samoa. See IRC sections 27(b) and 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



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October 13, 1995.<sup>509</sup> A corporation that added a substantial new line of business (other than in a qualifying acquisition of all the assets of a trade or business of an existing credit claimant) ceased to be an existing credit claimant as of the close of the taxable year ending before the date on which that new line of business was added.

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

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

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).

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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>509</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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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 12 taxable years of the corporation which begin after December 31, 2005, and before January 1, 2018. For any other corporation, the credit applies to the first six taxable years of that corporation which begin after December 31, 2011, and before January 1, 2018.

New Federal Law (IRC section 27)

The provision extends the credit for three years to apply (1) in the case of a corporation that is an existing credit claimant with respect to American Samoa<sup>510</sup> and that elected the application of IRC section 936 for its last taxable year beginning before January 1, 2006, to the first 15 taxable years of the corporation, which begin after December 31, 2005, and before January 1, 2021, and (2) in the case of any other corporation, to the first nine taxable years of the corporation, which begin after December 31, 2011, and before January 1, 2021.

Effective Date

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

California Law (None)

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

Impact on California Revenue

Not applicable.

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Subtitle C — Incentives for Energy Production, Efficiency,  
and Green Economy Jobs

<u>Section</u>	<u>Section Title</u>
121	Biodiesel and Renewable Diesel

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<sup>510</sup> American Samoa is part of the U.S. Virgin Islands as defined by IRC 936(d)(1).

## 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, 2017.

Biodiesel is monoalkyl esters of long chain fatty acids derived from plant or animal matter that meet (1) the registration requirements established by the Environmental Protection Agency (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.

The credit is not available for any sale or use for any period after December 31, 2017. 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

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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, 2017.

#### 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, 2017.

For fuel sold or used in 2017, a special rule addresses 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 Secretary was directed to issue guidance within 30 days of the date of enactment of the Bipartisan Budget Act of 2018.<sup>511</sup> 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.

#### New Federal Law (IRC sections 40A, 6426, 6427)

The provision extends the present-law income tax credit, excise tax credit, and payment provisions for biodiesel and renewable diesel through December 31, 2022. As it relates to fuel sold or used in the period beginning January 1, 2018, through the close of the last calendar quarter beginning before the date of enactment of this Act (December 20, 2019), the provision creates a special rule to address claims regarding

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<sup>511</sup> P.L. 115-123, Division D, Section 40407, enacted February 9, 2018.

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excise tax credits and claims for payment during such period. 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 the above period. 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, 2017.

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>
122	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, 2017.

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;

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or (2) used by the producer for any purpose described in (1)(a), (b), or (c).<sup>512</sup> Special rules apply for fuel derived from algae.

Second generation biofuel means any liquid fuel that (1) is produced in the U.S. and used as fuel in the U.S., (2) is derived by or from qualified feedstocks and (3) meets the registration requirements for fuels and fuel additives established by the 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.

New Federal Law (IRC section 40)

The provision extends the credit three years, through December 31, 2020.

Effective Date

The provision is effective for qualified second generation biofuel production after December 31, 2017.

California Law (None)

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

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<sup>512</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.



Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
123	Nonbusiness Energy Property

Background

Present law provides a 10-percent credit for the purchase of qualified energy efficiency improvements to existing homes.<sup>513</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>514</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 U.S. 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>515</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,

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<sup>513</sup> IRC section 25C.

<sup>514</sup> P.L. 111-5, February 17, 2009.

<sup>515</sup> Ibid.

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.

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>516</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>517</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 U.S. 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, 2018. 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

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<sup>516</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>517</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.

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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.

New Federal Law (IRC section 25C)

The provision extends the credit for three years, with respect to property placed into service through December 31, 2020, and includes technical amendments to the definition of "energy-efficient building property" that replace references to "energy factor" with "Uniform Energy Factor" and that change the Uniform Energy Factor from 2.0 to 2.2.

Effective Date

The provision is effective for property placed in service after December 31, 2017.

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>
124	Qualified Fuel Cell Motor Vehicles

Background

A credit is available through 2017 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

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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 three years, through December 31, 2020.

Effective Date

The provision is effective for property purchased after December 31, 2017.

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>
125	Alternative Fuel Refueling Property Credit

Background

Taxpayers may claim a 30-percent credit for the cost of installing qualified clean-fuel vehicle refueling property to be used in a trade or business of the taxpayer or installed at the principal residence of the taxpayer.<sup>518</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.

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<sup>518</sup> IRC section 30C.

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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 U.S. 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, 2018.

New Federal Law (IRC section 30C)

The provision extends for three years the 30-percent alternative fuel refueling property credit, through December 31, 2020.

Effective Date

The provision is effective for property placed in service after December 31, 2017.

California Law (None)

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

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
126	2-Wheeled Plug-in Electric Vehicle Credit

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Background

For vehicles acquired during 2015 through 2017, a 10-percent credit was available for qualifying 2-wheeled plug-in electric motorcycles.<sup>519</sup> Qualifying 2-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 three years the 10-percent 2-wheeled electric motorcycles credit, through December 31, 2020.

Effective Date

The provision is effective for vehicles acquired after December 31, 2017.

California Law (None)

California does not conform to the 2-wheeled plug-in electric vehicles credit.

Impact on California Revenue

Not applicable.

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<sup>519</sup> IRC section 30D(g).

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<u>Section</u>	<u>Section Title</u>
127	Credit for Electricity Produced 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>520</sup>

Qualified energy resources comprise wind, closed-loop biomass, open-loop biomass, geothermal energy, solar energy, small irrigation power, municipal solid waste, qualified hydropower production, and marine and hydrokinetic renewable energy.

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

Summary of Credit for Electricity Produced from Certain Renewable Resources

Eligible Electricity Production Activity (IRC section 45)	Credit Amount for 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, 2017
Open-loop biomass (including agricultural livestock waste nutrient facilities)	1.2	December 31, 2017
Geothermal	2.3	December 31, 2017
Municipal solid waste (including landfill gas facilities and trash combustion facilities)	1.2	December 31, 2017
Qualified hydropower	1.2	December 31, 2017
Marine & hydrokinetic	1.2	December 31, 2017

<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.

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<sup>520</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.



### 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.

### Qualified Wind Facilities Limitations

For qualified wind facilities the construction of which begins in 2017, the credits are limited to 80 percent of the otherwise available credit rate. For wind facilities the construction of which begins in 2018, the credits are limited to 60 percent of the otherwise available credit rate. For wind facilities the construction of which begins in 2019, the credits are limited to 40 percent of the otherwise available credit rate.

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

Except for wind facilities, the provision extends for three years the renewable electricity production credit and the election to claim the energy credit in lieu of the renewable electricity production credit through December 31, 2020.

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 renewable electricity production credit through December 31, 2020. Additionally, for wind facilities the construction of which begins in 2020, the credits are limited to 40 percent of the otherwise available credit rate.

### Effective Date

The provision is effective on January 1, 2018.

### California Law (None)

California does not conform to the credits with respect to electricity produced from certain renewable resources.

### Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
128	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 a twelve-year period beginning January 1, 2006, and ending December 31, 2017. The amount of the credit is \$2.00 per ton (adjusted for inflation; \$2.423 for 2017). 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 U.S. for a tribe or its members.

The credit is a component of the general business credit,<sup>521</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 three years through December 31, 2020.

Effective Date

The provision is effective for Indian coal produced after December 31, 2017.

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>
129	Energy Efficient Homes Credit

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<sup>521</sup> IRC section 38(b)(8).

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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 U.S., (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 acquired prior to January 1, 2018. The credit is part of the GBC.

New Federal Law (IRC section 45L)

The provision extends the credit to homes that are acquired prior to January 1, 2021.

Effective Date

The provision is effective for homes acquired after December 31, 2017.

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>
130	Special Allowance for Second Generation Biofuel Plant Property

Background

The additional first-year depreciation deduction is equal to 50 percent of the adjusted basis of qualified second generation biofuel plant property.<sup>522</sup> To qualify, the property generally must be placed in service before January 1, 2018.<sup>523</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 EPA under section 211 of the Clean Air Act.<sup>524</sup> Qualified feedstocks means any lignocellulosic or hemicellulosic matter that is available on a renewable or recurring basis<sup>525</sup> and any cultivated algae, cyanobacteria, or lemna.<sup>526</sup> Second generation biofuel does not include any alcohol with a proof of less than 150 or certain unprocessed fuel.<sup>527</sup> Unprocessed fuels are 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.<sup>528</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>529</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

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<sup>522</sup> IRC section 168(l).

<sup>523</sup> IRC section 168(l)(2)(D).

<sup>524</sup> IRC sections 168(l)(2)(A) and 40(b)(6)(E).

<sup>525</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>526</sup> IRC section 40(b)(6)(F).

<sup>527</sup> IRC sections 40(b)(6)(E)(ii) and (iii).

<sup>528</sup> IRC section 40(b)(6)(E)(iii).

<sup>529</sup> IRC section 168(l)(5).

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are appropriately adjusted to reflect the additional first-year depreciation deduction.<sup>530</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>531</sup>

A taxpayer is allowed to elect out of the additional first-year depreciation for any class of property for any taxable year.<sup>532</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, 2018.<sup>533</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, 2027, (and all other requirements are met).<sup>534</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>535</sup>

Recapture rules apply if the property ceases to be qualified second generation biofuel plant property.<sup>536</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>537</sup>

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<sup>530</sup> IRC section 168(l)(1)(B).

<sup>531</sup> IRC sections 168(l)(5) and (k)(2)(G).

<sup>532</sup> IRC section 168(l)(3)(D).

<sup>533</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>534</sup> IRC sections 168(l)(4) and (k)(2)(E).

<sup>535</sup> IRC section 168(l)(3)(C).

<sup>536</sup> IRC section 168(l)(6).

<sup>537</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 three years, to qualified second generation biofuel plant property placed in service prior to January 1, 2021.

Effective Date

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

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>538</sup> and that special allowance has not been adopted under the CTL.<sup>539</sup>

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
131	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 U.S. that is within the scope of Standard 90.1-2007 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

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<sup>538</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>539</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.

(iii) the building envelope, and (3) which is certified as being installed as part of a plan designed to reduce the total annual energy and power costs with respect to the interior lighting systems, heating, cooling, ventilation, and hot water systems of the building by 50 percent or more in comparison to a reference building which meets the minimum requirements of Standard 90.1-2007 (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>540</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, 2018.

#### 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

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<sup>540</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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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.

*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>541</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 90.1-2007. 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 three years through December 31, 2020.

Effective Date

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

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

This provision is not applicable under California Law.

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<sup>541</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.

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Under the PITL, California specifically does not conform to the federal election to expense energy efficient commercial buildings,<sup>542</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>543</sup> Taxpayers with a sufficiently small amount of annual investment may elect to deduct up to \$25,000 of the cost of qualifying property placed in service for the taxable year. The \$25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000. The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
132	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>544</sup> The realized gain is subject to current income tax<sup>545</sup> unless the recognition of the gain is deferred or excluded from income under a special tax provision.<sup>546</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

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<sup>542</sup> R&TC section 17257.2.

<sup>543</sup> R&TC sections 17255 and 24356.

<sup>544</sup> See IRC section 1001.

<sup>545</sup> See IRC sections 61 and 451(a).

<sup>546</sup> See, e.g., IRC sections 453, 1031, and 1033.

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purchase exempt utility property within the applicable period<sup>547</sup> (the reinvestment property).<sup>548</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, 2018.<sup>549</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>550</sup>) with respect to the transmission facilities to which the election applies, and (2) an electric utility (as defined in the Federal Power Act<sup>551</sup>).<sup>552</sup>

In general, an independent transmission company is defined as: (1) an independent transmission provider<sup>553</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>554</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>555</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

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<sup>547</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>548</sup> IRC section 451(k).

<sup>549</sup> IRC section 451(k)(3).

<sup>550</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.

<sup>551</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>552</sup> IRC section 451(k)(6).

<sup>553</sup> For example, a regional transmission organization, an independent system operator, or an independent transmission company.

<sup>554</sup> 16 U.S.C. section 824b.

<sup>555</sup> IRC section 451(k)(4).

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whose principal trade or business consists of the activities described in (1).<sup>556</sup> Exempt utility property does not include any property that is located outside of the U.S.<sup>557</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>558</sup>

#### TCJA<sup>559</sup> Provision Related to IRC Section 451

The TCJA provision revises the rules associated with the timing of the recognition of income.<sup>560</sup> Specifically, the TCJA provision requires an accrual method taxpayer subject to the all events test for an item of gross income to recognize such income no later than the taxable year in which such income is taken into account as revenue in an applicable financial statement<sup>561</sup> or another financial statement under rules

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<sup>556</sup> IRC section 451(k)(5).

<sup>557</sup> IRC section 451(k)(5)(C).

<sup>558</sup> IRC section 451(k)(7).

<sup>559</sup> P.L. 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>560</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 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 event 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>561</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 U.S. 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

specified by the Secretary, but provides an exception for taxpayers without an applicable or other specified financial statement.<sup>562</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>563</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 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>564</sup> and "excess" mortgage servicing rights will be treated as stripped coupons under IRC section 1286 and therefore subject to the OID rules.)<sup>565</sup>

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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>562</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 Treas. Reg. 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 Treas. Reg. section 1.446-1(c)(1)(iii).

<sup>563</sup> IRC sections 1271-1288.

<sup>564</sup> See Rev. Rul. 70-142, 1970-2 C.B. 115.

<sup>565</sup> See Rev. Rul. 91-46, 1991-2, C.B. 358, and Rev. Proc. 91-50, 1991-2 C.B. 778.

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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 Rev. Proc. 2004-34.<sup>566</sup> That is, the TCJA provision allows accrual method taxpayers to elect<sup>567</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>568</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 three years the treatment under the present-law deferral provision to sales or dispositions by a qualified electric utility that occur prior to January 1, 2021.

Effective Date

The provision applies to dispositions after December 31, 2017.

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>569</sup> however, both the PITL and the CTL specifically do not conform

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<sup>566</sup> 2004-1 C.B. 991, as modified and clarified by Rev. Proc. 2011-18, 2011-5 I.R.B. 443, and Rev. Proc. 2013-29, 2013-33 I.R.B. 141.

<sup>567</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>568</sup> Thus, the TCJA is intended to override any deferral method provided by Treas. Reg. section 1.451-5 for advance payments received for goods.

<sup>569</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



to the special rule for sales or dispositions to implement FERC or state electric restructuring policy.<sup>570</sup>

### Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
133	Extension and Clarification 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>571</sup> of non-liquid alternative fuel sold by the taxpayer for use as a motor fuel in a motor vehicle or motorboat, sold for use in aviation or so used by the taxpayer.

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the CTL, 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>570</sup> R&TC sections 17551(f) and 24661.6.

<sup>571</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 British thermal unit (BTU) content of 124,800 (higher heating value).



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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, 2017.

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, 2017.

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 section 6426)

The provision extends the alternative fuel credit and related payment provisions, and the alternative fuel mixture credit through December 31, 2020.

In light of the retroactive nature of the provision, as it relates to alternative fuel sold or used in the period beginning January 1, 2018, and ending with the close of the last calendar quarter beginning before the date of the enactment of this act (December 20, 2019), the provision creates a special rule to address claims regarding excise credits and claims for payment within this period.

In particular, the provision directs the Secretary to issue guidance within 30 days of the date of enactment (December 20, 2019). Such guidance is to provide for a one-time submission of claims covering the above period. 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>572</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.

The provision also removes liquefied petroleum gas, compressed or liquefied natural gas, and compressed or liquefied gas derived from biomass, from the definition of "alternative fuel mixture" for purposes of determining the alternative fuel mixture

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<sup>572</sup> This guidance is provided by Notice 2015-3, 2015-6 I.R.B 583.

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credit for fuel sold or used within the periods described under the effective dates below.

Effective Dates

For other than modification of the definition of alternative fuel mixture, the provision is effective for fuel sold or used after December 31, 2017.

The modification of the definition of alternative fuel mixture for purposes of determining the alternative fuel mixture credit is effective for:

- Fuel sold or used on or after December 20, 2019, and
- For fuel sold or used before December 20 2019, but only to the extent such sales or use:
  - Have not been paid or allowed, and
  - Were made after January 8, 2018.

California Law

The FTB does not administer these types of excise taxes.

Impact on California Revenue

The FTB does not administer these types of excise taxes.

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<u>Section</u>	<u>Section Title</u>
134	Oil Spill Liability Trust Fund Rate

Background

The Oil Spill Liability Trust Fund financing rate (“oil spill tax”) was reinstated effective April 1, 2006.<sup>573</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 U.S. for consumption, use, or warehousing.<sup>574</sup>

The oil spill tax also applies to certain uses and the exportation of domestic crude oil.<sup>575</sup> If any domestic crude oil is used in or exported from the U.S., and before such use or exportation no oil spill tax was imposed on such crude oil, then the oil spill tax is

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<sup>573</sup> IRC section 4611(f).

<sup>574</sup> The term “crude oil” includes crude oil condensates and natural gasoline. The term “petroleum product” includes crude oil.

<sup>575</sup> The term “domestic crude oil” means any crude oil produced from a well located in the U.S.

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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, 2018.

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 beginning January 1, 2017.

New Federal Law (IRC section 4611)

The provision extends the oil spill tax through December 31, 2020.

Effective Date

The provision is effective on or after the first day of the first calendar month beginning after the date of enactment (December 20, 2019).

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 —Certain Provisions Expiring at the End of 2019

<u>Section</u>	<u>Section Title</u>
141	New Markets Tax Credit

Background

IRC section 45D provides a new markets tax credit for qualified equity investments made to acquire stock in a corporation, or a capital interest in a partnership, that is a qualified community development entity (CDE).<sup>576</sup> The amount of the credit allowable to the investor (either the original purchaser or a subsequent holder) is (1) a five-percent credit for the year in which the equity interest is purchased from the CDE and for each of the following two years, and (2) a six-percent credit for each of the following four years.<sup>577</sup> The credit is determined by applying the applicable percentage (five or six percent) to the amount paid to the CDE for the investment at its original issue, and is available to the taxpayer who holds the qualified equity investment on the date of the initial investment or on the respective anniversary date that occurs during the taxable year.<sup>578</sup> The credit is recaptured if at any time during the seven-year period that begins on the date of the original issue of the investment the entity (1) ceases to be a qualified CDE, (2) the proceeds of the investment cease to be used as required, or (3) the equity investment is redeemed.<sup>579</sup>

A qualified CDE is any domestic corporation or partnership: (1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons; (2) that maintains accountability to residents of low-income communities by their representation on any governing board of or any advisory board to the CDE; and (3) that is certified by the Secretary as being a qualified CDE.<sup>580</sup> A qualified equity investment means stock (other than nonqualified preferred stock) in a corporation or a capital interest in a partnership that is acquired at its original issue directly (or through an underwriter) from a CDE for cash, and includes an investment of a subsequent purchaser if such investment was a qualified equity investment in the hands of the prior holder.<sup>581</sup> Substantially all of the investment proceeds must be used by the CDE to make qualified low-income community investments and the investment must be designated as a qualified equity investment by the CDE. For this purpose, qualified low-income community investments include: (1) capital or equity investments in, or loans to, qualified active low-income community businesses;

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<sup>576</sup> IRC section 45D was added by section 121(a) of the Community Renewal Tax Relief Act of 2000, P.L. 106-554.

<sup>577</sup> IRC section 45D(a)(2).

<sup>578</sup> IRC section 45D(a)(3).

<sup>579</sup> IRC section 45D(g).

<sup>580</sup> IRC section 45D(c).

<sup>581</sup> IRC section 45D(b).

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(2) certain financial counseling and other services to businesses and residents in low-income communities; (3) the purchase from another CDE of any loan made by such entity that is a qualified low-income community investment; or (4) an equity investment in, or loan to, another CDE.<sup>582</sup>

A “low-income community” is a population census tract with either (1) a poverty rate of at least 20 percent or (2) median family income which does not exceed 80 percent of the greater of metropolitan area median family income or statewide median family income (for a nonmetropolitan census tract, does not exceed 80 percent of statewide median family income). In the case of a population census tract located within a high migration rural county, low income is defined by reference to 85 percent (as opposed to 80 percent) of statewide median family income.<sup>583</sup> For this purpose, a high migration rural county is any county that, during the 20-year period ending with the year in which the most recent census was conducted, has a net 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 low-income communities for purposes of the new markets tax credit.<sup>584</sup> For this purpose, a “targeted population” is defined by reference to section 103(20) of the Riegle Community Development and Regulatory Improvement Act of 1994<sup>585</sup> (the “Act”) to mean individuals, or an identifiable group of individuals, including an Indian tribe, who are low-income persons or otherwise lack adequate access to loans or equity investments. Section 103(17) of the Act provides that “low income” means (1) for a targeted population within a metropolitan area, less than 80 percent of the area median family income; and (2) for a targeted population within a non-metropolitan area, less than the greater of 80 percent of the area median family income, or 80 percent of the statewide non-metropolitan area median family income.<sup>586</sup> A targeted population is not required to be within any census tract. In addition, a population census tract with a population of less than 2,000 is treated as a low-income community for purposes of the credit if such tract is within an empowerment zone, the designation of which is in effect under IRC section 1391, and is contiguous to one or more low-income communities.

A qualified active low-income community business is defined as a business that satisfies, with respect to a taxable year, the following requirements: (1) at least 50 percent of the total gross income of the business is derived from the active conduct of trade or business activities in any low-income community; (2) a substantial portion of the tangible property of the business is used in a low-income

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<sup>582</sup> IRC section 45D(d).

<sup>583</sup> IRC section 45D(e).

<sup>584</sup> IRC section 45D(e)(2).

<sup>585</sup> P.L. 103-325.

<sup>586</sup> P.L. 103-325.

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community; (3) a substantial portion of the services performed for the business by its employees is performed in a low-income community; and (4) less than five percent of the average of the aggregate unadjusted bases of the property of the business is attributable to certain financial property or to certain collectibles.<sup>587</sup>

The maximum annual amount of qualified equity investments was \$3.5 billion for calendar years 2010 through 2019.<sup>588</sup>

No amount of unused allocation limitation may be carried to any calendar year after 2024.<sup>589</sup>

New Federal Law (IRC section 45D)

The provision extends the new markets tax credit for one year through 2025 to \$5 billion for calendar year 2020. The provision also extends the carryover period for unused new markets tax credits for one year through 2025.

Effective Date

The provision applies to calendar years beginning after December 31, 2019.

California Law (None)

California does not conform to the federal new markets tax credit.

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<sup>587</sup> IRC section 45D(d)(2).

<sup>588</sup> IRC section 45D(f)(1).

<sup>589</sup> IRC section 45D(f)(3).

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
142	Employer Credit for Paid Family and Medical Leave

Background

Eligible employers may claim a general business credit equal to 12.5 percent of the amount of wages paid to qualifying employees during any period in which such employees are on family and medical leave if the rate of payment under the program is 50 percent of the wages normally paid to an employee. The credit is increased by 0.25 percentage points (but not above 25 percent) for each percentage point by which the rate of payment exceeds 50 percent. The maximum amount of family and medical leave that may be taken into account with respect to any employee for any taxable year is 12 weeks. The credit is not available for wages paid after December 31, 2019.

An eligible employer is one who has in place a written policy that allows all qualifying full-time employees not less than two weeks of annual paid family and medical leave, and who allows all less-than-full-time qualifying employees a commensurate amount of leave in proportion to the part-time employee's expected work hours. For purposes of this requirement, leave paid for by a State or local government is not taken into account. A "qualifying employee" means any employee, as defined in section 3(e) of the Fair Labor Standards Act of 1938, who has been employed by the employer for one year or more, and who for the preceding year, had compensation not in excess of 60 percent of the compensation threshold for highly compensated employees.<sup>590</sup> The Secretary will make determinations as to whether an employer or an employee satisfies the applicable requirements for an eligible employer or qualifying employee, based on information provided by the employer.

"Family and medical leave" is defined as leave described under sections 102(a)(1)(a)-(e) or 102(a)(3) of the Family and Medical Leave Act of 1993.<sup>591</sup> If an employer provides paid leave as vacation leave, personal leave, or other

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<sup>590</sup> IRC section 414(q)(1)(B) (\$80,000 for 2019).

<sup>591</sup> In order to be an eligible employer, an employer must provide certain protections applicable under the Family and Medical Leave Act of 1993, regardless of whether they otherwise apply. Specifically, the employer must provide paid family and medical leave in compliance with a policy, which ensures that the employer will not interfere with, restrain, or deny the exercise of or the attempt to exercise, any right provided under the policy, and will not discharge or in any other manner discriminate against any individual for opposing any practice prohibited by the policy.



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medical or sick leave, this paid leave would not be considered to be family and medical leave.

New Federal Law (IRC section 45S)

This provision extends the credit for one year, by providing that it will not apply to wages paid in taxable years beginning after December 31, 2020.

Effective Date

The provision is effective for wages paid in taxable years beginning after December 31, 2019, and would not apply to wages paid in taxable years beginning after December 31, 2020.

California Law (None)

California does not conform to IRC section 45S, relating to the new employer credit for paid family and medical leave, and has no comparable credit.

California extends disability compensation to people who take time off work to care for a seriously ill child, spouse, parent, domestic partner, or to bond with a new baby or adopted child. Because the benefits paid are in the nature of unemployment compensation, California law considers it nontaxable income for state purposes. The Paid Family Leave program is part of the State Disability Insurance program administered by the Employment Development Department (EDD).

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
143	Work Opportunity Tax Credit

Background

In General

The WOTC is available on an elective basis for employers hiring individuals from one or more of nine targeted groups. The amount of the credit available to an employer is determined by the amount of qualified wages paid by the employer. Generally, qualified wages consist of wages attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual

begins work for the employer (two years in the case of an individual in the long-term family assistance recipient category).

#### Targeted Groups Eligible for the Credit

Generally, an employer is eligible for the credit only for qualified wages paid to members of a targeted group, which include:

##### (1) *Qualified IV-A Recipient*

An eligible recipient is an individual certified by a designated local agency as being a member of a family receiving assistance under Part A of Title IV of the SSA relating to temporary assistance for needy families for any nine months during the 18-month period ending on the hiring date.<sup>592</sup>

##### (2) *Qualified Veteran*

Prior to enactment of the "VOW to Hire Heroes Act of 2011" (the "VOW Act"),<sup>593</sup> there were two subcategories of qualified veterans to whom wages paid by an employer were eligible for the credit. Employers who hired veterans who were eligible to receive assistance under a supplemental nutritional assistance program were entitled to a maximum credit of 40 percent of \$6,000 of qualified first-year wages paid to such individual.<sup>594</sup> Employers who hired veterans who were entitled to compensation for a service-connected disability were entitled to a maximum wage credit of 40 percent of \$12,000 of qualified first-year wages paid to such individual.<sup>595</sup>

The VOW Act modified the work opportunity credit with respect to qualified veterans, by adding additional subcategories. There are now five subcategories of qualified veterans: (1) in the case of veterans who were eligible to receive assistance under a supplemental nutritional assistance

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<sup>592</sup> IRC section 51(d)(2).

<sup>593</sup> P.L. 112-56 (November 21, 2011).

<sup>594</sup> For these purposes, a qualified veteran must be certified by the designated local agency as a member of a family receiving assistance under a supplemental nutrition assistance program under the Food and Nutrition Act of 2008 for a period of at least three months part of which is during the 12-month period ending on the hiring date. For these purposes, members of a family are defined to include only those individuals taken into account for purposes of determining eligibility for a supplemental nutrition assistance program under the Food and Nutrition Act of 2008.

<sup>595</sup> The qualified veteran must be certified as entitled to compensation for a service-connected disability and: (1) have a hiring date which is not more than one year after having been discharged or released from active duty in the Armed Forces of the U.S., or (2) have been unemployed for six months or more (whether or not consecutive) during the one-year period ending on the date of hiring. For these purposes, being entitled to compensation for a service-connected disability is defined with reference to Section 101 of Title 38, U.S.C., which means having a disability rating of 10 percent or higher for service connected injuries.

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program (for at least a three month period during the year prior to the hiring date) the employer is entitled to a maximum credit of 40 percent of \$6,000 of qualified first-year wages; (2) in the case of a qualified veteran who is entitled to compensation for a service connected disability, who is hired within one year of discharge, the employer is entitled to a maximum credit of 40 percent of \$12,000 of qualified first-year wages; (3) in the case of a qualified veteran who is entitled to compensation for a service-connected disability, and who has been unemployed for an aggregate of at least six months during the one year period ending on the hiring date, the employer is entitled to a maximum credit of 40 percent of \$24,000 of qualified first-year wages; (4) in the case of a qualified veteran unemployed for at least four weeks but less than six months (whether or not consecutive) during the one-year period ending on the date of hiring, the maximum credit equals 40 percent of \$6,000 of qualified first-year wages; and (5) in the case of a qualified veteran unemployed for at least six months (whether or not consecutive) during the one-year period ending on the date of hiring, the maximum credit equals 40 percent of \$14,000 of qualified first-year wages.

A veteran is an individual who has served on active duty (other than for training) in the Armed Forces for more than 180 days or who has been discharged or released from active duty in the Armed Forces for a service-connected disability. However, any individual who has served for a period of more than 90 days during which the individual was on active duty (other than for training) is not a qualified veteran if any of this active duty occurred during the 60-day period ending on the date the individual was hired by the employer. This latter rule is intended to prevent employers who hire current members of the armed services (or those departed from service within the last 60 days) from receiving the credit.

*(3) Qualified Ex-felon*

A qualified ex-felon is an individual certified as: (1) having been convicted of a felony under any state or federal law, and (2) having a hiring date within one year of release from prison or the date of conviction.

*(4) Designated Community Resident*

A designated community resident is an individual certified as being at least age 18 but not yet age 40 on the hiring date and as having a principal place of abode within an empowerment zone, enterprise community, renewal community, or a rural renewal community. For these purposes, a rural renewal county is a county outside a metropolitan statistical area (as defined by the Office of Management and Budget), which had a net population loss during the five-year periods 1990–1994 and 1995–1999.

Qualified wages do not include wages paid or incurred for services performed after the individual moves outside an empowerment zone, enterprise community, renewal community, or a rural renewal community.

*(5) Vocational Rehabilitation Referral*

A vocational rehabilitation referral is an individual who is certified by a designated local agency as an individual who has a physical or mental disability that constitutes a substantial handicap to employment and who has been referred to the employer while receiving, or after completing: (a) vocational rehabilitation services under an individualized, written plan for employment under a state plan approved under the Rehabilitation Act of 1973, (b) under a rehabilitation plan for veterans carried out under Chapter 31 of Title 38, U.S.C., or (c) an individual work plan developed and implemented by an employment network pursuant to Subsection (g) of Section 1148 of the SSA. Certification will be provided by the designated local employment agency upon assurances from the vocational rehabilitation agency that the employee has met the above conditions.

*(6) Qualified Summer Youth Employee*

A qualified summer youth employee is an individual: (1) who performs services during any 90-day period between May 1 and September 15, (2) who is certified by the designated local agency as being 16 or 17 years of age on the hiring date, (3) who has not been an employee of that employer before, and (4) who is certified by the designated local agency as having a principal place of abode within an empowerment zone, enterprise community, or renewal community. As with designated community residents, no credit is available on wages paid or incurred for service performed after the qualified summer youth moves outside of an empowerment zone, enterprise community, or renewal community. If, after the end of the 90-day period, the employer continues to employ a youth who was certified during the 90-day period as a member of another targeted group, the limit on qualified first-year wages will take into account wages paid to the youth while a qualified summer youth employee.

*(7) Qualified Supplemental Nutrition Assistance Program Benefits Recipient*

A qualified supplemental nutrition assistance program benefits recipient is an individual at least age 18 but not yet age 40 certified by a designated local employment agency as being a member of a family receiving assistance under a food and nutrition program under the Food and Nutrition Act of 2008 for a period of at least six months ending on the hiring date. In the case of families that cease to be eligible for food and nutrition assistance under Section 6(o) of the Food and Nutrition Act of 2008, the

six-month requirement is replaced with a requirement that the family has been receiving food and nutrition assistance for at least three of the five months ending on the date of hire. For these purposes, members of the family are defined to include only those individuals taken into account for purposes of determining eligibility for a food and nutrition assistance program under the Food and Nutrition Act of 2008.

*(8) Qualified Supplemental Security Income (SSI) Recipient*

A qualified SSI recipient is an individual designated by a local agency as receiving SSI benefits under Title XVI of the SSA for any month ending within the 60-day period ending on the hiring date.

*(9) Long-term Family Assistance Recipient*

A qualified long-term family assistance recipient is an individual certified by a designated local agency as being: (1) a member of a family that has received family assistance for at least 18 consecutive months ending on the hiring date, (2) a member of a family that has received such family assistance for a total of at least 18 months (whether or not consecutive) after August 5, 1997, (the date of enactment of the welfare-to-work tax credit)<sup>596</sup> if the individual is hired within two years after the date that the 18-month total is reached, or (3) a member of a family who is no longer eligible for family assistance because of either federal or state time limits, if the individual is hired within two years after the federal or state time limits made the family ineligible for family assistance.

*(10) Qualified Long-term Unemployment Recipient*

A qualified long-term unemployment recipient is an individual certified by a designated local agency as being in a period of unemployment of 27 consecutive weeks or more, which includes a period in which the individual was receiving unemployment compensation under state or federal law.

## Qualified Wages

Generally, qualified wages are defined as cash wages paid by the employer to a member of a targeted group. The employer's deduction for wages is reduced by the amount of the credit. For purposes of the credit, generally, wages are defined by reference to the Federal Unemployment Tax Act (FUTA) definition of wages contained in IRC section 3306(b) (without regard to the dollar limitation therein

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<sup>596</sup> The welfare-to-work tax credit was consolidated into the WOTC in the Tax Relief and Health Care Act of 2006, P.L. 109-432, for qualified individuals who begin to work for an employer after December 31, 2006.

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contained). Special rules apply in the case of certain agricultural labor and certain railroad labor.

#### Calculation of the Credit

The credit available to an employer for qualified wages paid to members of all targeted groups except for long-term family assistance recipients equals 40 percent (25 percent for employment of 400 hours or less) of qualified first-year wages. Generally, qualified first-year wages are qualified wages (not in excess of \$6,000) attributable to service rendered by a member of a targeted group during the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is \$2,400 (40 percent of the first \$6,000 of qualified first-year wages). With respect to qualified summer youth employees, the maximum credit is \$1,200 (40 percent of the first \$3,000 of qualified first-year wages). Except for long-term family assistance recipients, no credit is allowed for second-year wages.

In the case of long-term family assistance recipients, the credit equals 40 percent (25 percent for employment of 400 hours or less) of \$10,000 for qualified first-year wages and 50 percent of the first \$10,000 of qualified second-year wages. Generally, qualified second-year wages are qualified wages (not in excess of \$10,000) attributable to service rendered by a member of the long-term family assistance category during the one-year period beginning on the day after the one-year period beginning with the day the individual began work for the employer. Therefore, the maximum credit per employee is \$9,000 (40 percent of the first \$10,000 of qualified first-year wages plus 50 percent of the first \$10,000 of qualified second-year wages).

For calculation of the credit with respect to qualified veterans, see the description of "qualified veteran" above.

#### Certification Rules

Generally, an individual is not treated as a member of a targeted group unless: (1) on or before the day on which an individual begins work for an employer, the employer has received a certification from a designated local agency that such individual is a member of a targeted group, or (2) on or before the day an individual is offered employment with the employer, a pre-screening notice is completed by the employer with respect to such individual, and not later than the 28th day after the individual begins work for the employer, the employer submits such notice, signed by the employer and the individual under penalties of perjury, to the designated local agency as part of a written request for certification. For these purposes, a pre-screening notice is a document (in such form as the Secretary may prescribe) which contains information provided by the individual on the basis of which the employer believes that the individual is a member of a targeted group.



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An otherwise qualified unemployed veteran is treated as certified by the designated local agency as having aggregate periods of unemployment (whichever is applicable under the qualified veterans rules described above) if such veteran is certified by such agency as being in receipt of unemployment compensation under a state or federal law for such applicable periods. The Secretary is authorized to provide alternative methods of certification for unemployed veterans.

#### Minimum Employment Period

No credit is allowed for qualified wages paid to employees who work less than 120 hours in the first year of employment.

#### Qualified Tax-Exempt Organizations Employing Qualified Veterans

The credit is not available to qualified tax-exempt organizations other than those employing qualified veterans. The special rules, described below, were enacted in the VOW Act.

If a qualified tax-exempt organization employs a qualified veteran (as described above), a tax credit against the Federal Insurance Contributions Act (FICA) taxes of the organization is allowed on the wages of the qualified veteran which are paid for the veteran's services in furtherance of the activities related to the function or purpose constituting the basis of the organization's exemption under IRC section 501.

The credit available to such tax-exempt employer for qualified wages paid to a qualified veteran equals 26 percent (16.25 percent for employment of 400 hours or less) of qualified first-year wages. The amount of qualified first-year wages eligible for the credit is the same as those for non-tax-exempt employers (i.e., \$6,000, \$12,000, \$14,000 or \$24,000, depending on the category of qualified veteran).

A qualified tax-exempt organization means an employer that is described in IRC section 501(c) and exempt from tax under IRC section 501(a).

The Social Security Trust Funds are held harmless from the effects of this provision by a transfer from the Treasury General Fund.

#### Treatment of U.S. Possessions

The VOW Act provided a reimbursement mechanism for U.S. possessions (i.e., American Samoa, Guam, the Commonwealth of the Northern Mariana Islands, the Commonwealth of Puerto Rico, and the U.S. Virgin Islands). The Secretary is to pay to each mirror code possession (i.e., Guam, the Commonwealth of the Northern Mariana Islands, and the U.S. Virgin Islands) an amount equal to the loss to that possession as a result of the VOW Act changes to the qualified veterans rules. Similarly, the Secretary is to pay to each non-mirror IRC possession (i.e., American



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Samoa and the Commonwealth of Puerto Rico) the amount that the Secretary estimates as being equal to the loss to that possession that would have occurred as a result of the VOW Act changes if a mirror code tax system had been in effect in that possession. The Secretary will make this payment to a non-mirror IRC possession only if that possession establishes to the satisfaction of the Secretary that the possession has implemented (or, at the discretion of the Secretary, will implement) an income tax benefit that is substantially equivalent to the qualified veterans credit allowed under the VOW Act modifications.

An employer that is allowed a credit against U.S. tax under the VOW Act with respect to a qualified veteran must reduce the amount of the credit claimed by the amount of any credit (or, in the case of a non-mirror IRC possession, another tax benefit) that the employer claims against its possession income tax.

#### Other Rules

The WOTC is not allowed for wages paid to a relative or dependent of the taxpayer. No credit is allowed for wages paid to an individual who is a more than 50-percent owner of the entity. Similarly, wages that are paid to replacement workers during a strike or lockout are not eligible for the WOTC. Wages paid to any employee during any period for which the employer received on-the-job training program payments with respect to that employee are not eligible for the WOTC. The WOTC generally is not allowed for wages paid to individuals who had previously been employed by the employer. In addition, many other technical rules apply.

#### Expiration

The WOTC is not available for wages paid to individuals who begin work for an employer after December 31, 2019.

#### New Federal Law (IRC section 51)

The provision extends for one year the present-law employment credit provision through taxable years beginning on or before December 31, 2020.

#### Effective Date

The provision is effective for individuals who begin work for the employer after December 31, 2019, but will not be available for wages paid to an individual who begins work for the employer after December 31, 2020.

#### California Law (None)

California does not conform to the federal WOTC allowed under IRC section 51.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
144	Certain Provisions Related to Beer, Wine, and Distilled Spirits

Background

Subsection (a), Exemption for Aging Process of Beer, Wine, and Distilled Spirits

*In General*

The uniform capitalization (UNICAP) rules, which were enacted as part of the Tax Reform Act of 1986,<sup>597</sup> require certain direct and indirect costs allocable to real or tangible personal property produced by the taxpayer to be included in either inventory or capitalized into the basis of such property, as applicable.<sup>598</sup> For real or personal property acquired by the taxpayer for resale, IRC section 263A generally requires certain direct and indirect costs allocable to such property to be included in inventory.

In the case of interest expense, the UNICAP rules apply only to interest paid or incurred during the property's production period<sup>599</sup> and that is allocable to property produced by the taxpayer which (1) is either real property or property with a class life of at least 20 years, (2) has an estimated production period exceeding two years, or (3) has an estimated production period exceeding one year and a cost exceeding \$1,000,000.<sup>600</sup> The production period with respect to any property is the period beginning on the date on which production of the property begins, and ending on the date on which the property is ready to be placed in service or held for sale.<sup>601</sup> In the case of property that is customarily aged (e.g., tobacco and whiskey) before it is sold, the production period includes the aging period.<sup>602</sup>

The provision excludes the aging periods for beer, wine, and distilled spirits from the production period for purposes of the UNICAP interest capitalization rules. Thus,

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<sup>597</sup> IRC section 803(a) of P.L. No. 99-514 (1986).

<sup>598</sup> IRC section 263A.

<sup>599</sup> See Treas. Reg. section 1.263A-12.

<sup>600</sup> IRC section 263A (f).

<sup>601</sup> IRC section 263A (f)(4)(B).

<sup>602</sup> See Treas. Reg. section 1.263A-12(d)(1). See also Technical Advice Memorandum 9327007, March 31, 1993, holding that producers of wine must include the time that wine ages in bottles as part of the production period, which concludes when the wine vintage is officially released to the distribution chain.

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under the provision, producers of beer, wine and distilled spirits are able to deduct interest expenses (subject to any other applicable limitation) attributable to a shorter production period.

New Federal Law (IRC section 263A)

The application of these provisions was extended from applying to interest costs paid or accrued after December 31, 2019, to applying to interest costs paid or accrued after December 31, 2020.

Effective Date

The provision is effective for interest costs paid or accrued after December 31, 2019.

California Law (R&TC sections 17201 and 24422.3)

California conforms, under the PITL and CTL, to the federal rules for capitalization and inclusion in inventory for costs of certain expenses, also known as the UNICAP rules, under IRC section 263A, as of the "specified date" of January 1, 2015,<sup>603</sup> but does not conform to the exception to the UNICAP rules for the allocation of interest for the production period for beer, wine, and distilled spirits.

Impact on California Revenue

Estimated Conformity Revenue Impact of Exemption for Aging Process of Beer, Wine, and Distilled Spirits

For Taxable Years Beginning On or After January 1, 2020  
Enactment Assumed After June 30, 2020

2019-2020	2020-2021	2021-2022	2022-2023
N/A	-\$900,000	\$100,000	\$200,000

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<sup>603</sup> R&TC sections 17024.5 and 23051.5.

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Subsection (b), Reduced Rate of Excise Tax on Beer

Background

Federal excise taxes are imposed at different rates on distilled spirits, wine, and beer and are imposed on these products when produced or imported. Generally, these excise taxes are administered and enforced by the FTB, except the taxes on imported bottled distilled spirits, wine, and beer are collected by the Customs and Border Protection Bureau (the CBP) of the Department of Homeland Security (under delegation by the Secretary).

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.

The rate of tax on beer is \$18 per barrel (31 gallons).<sup>604</sup> For beer removed after December 31, 2017, and before January 1, 2020, the rate of tax on beer is \$16 per barrel on the first six million barrels brewed by the brewer or imported by the importer. Beer brewed or imported in excess of the six million barrel limit would continue to be taxed at \$18 per barrel. Small brewers are subject to a reduced tax rate of \$7 (\$3.50 in the case of beer removed after December 31, 2017, and before January 1, 2020,) per barrel on the first 60,000 barrels of beer domestically produced and removed each year.<sup>605</sup> Small brewers are defined as brewers producing fewer than two million barrels of beer during a calendar year.

New Federal Law (IRC section 5051(a))

The provision extends the reduced tax rate on beer of \$16 on the first 6,000,000 barrels of beer, and \$3.50 on the first 60,000 barrels for small breweries for one year to beer removed before January 1, 2021.

Effective Date

The provision applies to beer removed after December 31, 2019.

California Law

The FTB does not administer these types of excise taxes.

Impact on California Revenue

Not applicable.

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<sup>604</sup> IRC section 5051.

<sup>605</sup> IRC section 5051(a)(2).

## Subsection (c), Transfer of Beer Between Bonded Facilities

### Background

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.

Certain removals or transfers of beer are exempt from tax. Beer may be transferred without payment of the tax between breweries owned by the same brewer under certain conditions specified in the regulations.<sup>606</sup>

IRC section 5414(b) relaxes the shared ownership requirement of IRC section 5414(a) for bonded breweries. Thus, under the provision, a brewer may transfer beer from one brewery to another without incurring tax, provided that: (i) the breweries are owned by the same person; (ii) one brewery owns a controlling interest in the other; (iii) the same person or persons have a controlling interest in both breweries; or (iv) the proprietors of the transferring and receiving premises are independent of each other, and the transferor has divested itself of all interest in the beer so transferred, and the transferee has accepted responsibility for payment of the tax.

For purposes of transferring the tax liability, such relief from liability shall be effective from the time of removal from the transferor's bonded premises, or from the time of divestment, whichever is later.<sup>607</sup>

The provision related to bonded breweries does not apply to calendar quarters beginning after December 31, 2019.

### New Federal Law (IRC section 5414(b)(3))

The provision extends the termination date of this subsection from not applying to calendar quarters beginning after December 31, 2019, to not applying to calendar quarters beginning after December 31, 2020.

### Effective Date

The provision applies to any calendar quarters beginning after December 31, 2019.

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<sup>606</sup> IRC section 5414.

<sup>607</sup> IRC section 5414(b)(2).

## California Law

The FTB does not administer these types of excise taxes.

## Impact on California Revenue

Not applicable.

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## Subsection (d), Reduced Rate of Excise Tax on Certain Wines

### Background

#### In General

Under present law, excise taxes are imposed at different rates on wine, depending on the wine's alcohol content and carbonation levels.

#### Reduced Rates and Exemptions for Certain Wine Producers

Wineries having aggregate annual production not exceeding 250,000 gallons ("small domestic producers") receive a credit against the wine excise tax equal to 90 cents per gallon (the amount of a wine tax increase enacted in 1990) on the first 100,000 gallons of wine domestically produced and removed during a calendar year.<sup>608</sup> The credit is reduced (but not below zero) by one percent for each 1,000 gallons produced in excess of 150,000 gallons; the credit does not apply to sparkling wines.<sup>609</sup>

There are special rules for wine removed after December 31, 2017, and before January 1, 2020, that makes the credit against the wine excise tax for small domestic producers, available for all wine producers and importers and sparkling wine producers and importers. These rules also modify the amount of the credit, with respect to wine produced in, or imported into, the United States during a calendar year, to be (1) \$1.00 per wine gallon for the first 30,000 wine gallons of wine, plus; (2) 90 cents per wine gallon on the next 100,000 wine gallons of wine, plus; (3) 53.5 cents per wine gallon on the next 620,000 wine gallons of wine.<sup>610</sup> There is no phase-out of the credit and no 250,000 gallon limit.

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<sup>608</sup> IRC section 5041(c).

<sup>609</sup> IRC section 5041(c)(1) and (2).

<sup>610</sup> The credit rate for hard cider is tiered at the same level of production or importation, but is equal to 6.2 cents, 5.6 cents, and 3.3 cents, respectively.

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Federal Law (IRC section 5041)

This provision extended those special rules to wine removed before January 1, 2021.

Effective Date

The provision applies to wine removed after December 31, 2019.

California Law

The FTB does not administer these types of excise taxes.

Impact on California Revenue

Not applicable.

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Subsection (e), Adjustment of Alcohol Content Level for Application of Excise Taxes

Background

In General

Under present law, excise taxes are imposed at different rates on wine, depending on the wine's alcohol content and carbonation levels. The following table outlines the present rates of tax on wine.

Tax on Wine (IRC section 5041)	Tax Rates Per Wine Gallon
"Still wines" <sup>611</sup> not more than 14% alcohol	\$1.07
"Still wines" more than 14%, but not more than 21%, alcohol	\$1.57
"Still wines" more than 21%, but not more than 24%, alcohol	\$3.15
"Still wines" more than 24% alcohol	\$13.50 per proof gallon (taxed as distilled spirits)
Champagne and other sparkling wines	\$3.40
Artificially carbonated wines	\$3.30

For "still wines" removed after December 31, 2017, and before January 1, 2020, the 14 percent of alcohol that qualifies the wine for a specific tax rate is increased to 16 percent.

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<sup>611</sup> A "still wine" is a non-sparkling wine. Most common table wines are still wines.



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Federal Law (IRC section 5041)

This provision extends the increased percentage of 16 percent for one year for wine removed before January 1, 2021.

Effective Date

The provision applies to wine removed after December 31, 2019.

California Law

The FTB does not administer these types of excise taxes.

Impact on California Revenue

Not applicable.

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Subsection (f), Definition of Mead and Low Alcohol By Volume Wine

Background

In General

Under present law, excise taxes are imposed at different rates on wine, depending on the wine's alcohol content and carbonation levels. The following table outlines the present rates of tax on wine.

Tax on Wine (IRC section 5041)	Tax Rates Per Wine Gallon
"Still wines" <sup>612</sup> not more than 14% alcohol	\$1.07
"Still wines" more than 14%, but not more than 21%, alcohol	\$1.57
"Still wines" more than 21%, but not more than 24%, alcohol	\$3.15
"Still wines" more than 24% alcohol	\$13.50 per proof gallon (taxed as distilled spirits)
Champagne and other sparkling wines	\$3.40
Artificially carbonated wines	\$3.30

For "still wines" removed after December 31, 2017, and before January 1, 2020, the 14 percent of alcohol that qualifies the wine for a specific tax rate is increased to 16 percent.

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<sup>612</sup> A "still wine" is a non-sparkling wine. Most common table wines are still wines.

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Mead and low alcohol by volume wines are taxed at the lowest rate applicable to “still wine,” of \$1.07 per wine gallon of wine. Mead is defined as a wine that contains not more than 0.64 grams of carbon dioxide per hundred milliliters of wine,<sup>613</sup> which is derived solely from honey and water, contains no fruit product or fruit flavoring, and contains less than 8.5 percent alcohol-by-volume. The low alcohol by volume wines are eligible to be taxed at the lowest rate and are those wines that contain not more than 0.64 grams of carbon dioxide per hundred milliliters of wine,<sup>614</sup> which are derived primarily from grapes or grape juice concentrate and water, which contain no fruit flavoring other than grape, and which contain less than 8.5 percent alcohol by volume. The subsection that relates to mead and low alcohol by volume wine does not apply to wine removed after December 31, 2019.

New Federal Law (IRC 5041(h))

This provision extends the termination date of the provisions related to mead and low alcohol by volume wine by one year to make those provisions inapplicable to wine removed after December 31, 2020.

Effective Date

This provision applies to wine removed after December 31, 2019.

California Law

The FTB does not administer these types of excise taxes.

Impact on California Revenue

Not applicable.

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Subsection (g), Reduced Rate of Excise Tax on Certain Distilled Spirits

Background

An excise tax is imposed on all distilled spirits produced in, or imported into, the U.S.<sup>615</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

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<sup>613</sup> The Secretary is authorized to prescribe tolerances to this limitation as may be reasonably necessary in good commercial practice.

<sup>614</sup> The Secretary is authorized to prescribe tolerances to this limitation as may be reasonably necessary in good commercial practice.

<sup>615</sup> IRC section 5001.

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removal from the distillery, or, in the case of an imported product, from customs custody or bond.<sup>616</sup>

Distilled spirits are taxed at a rate of \$13.50 per proof gallon.<sup>617</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.

There is a temporary reduced tiered rate for distilled spirits. The rate of tax is lowered to \$2.70 per proof gallon on the first 100,000 proof gallons of distilled spirits, \$13.34 for all proof gallons in excess of that amount but below 22,130,000 proof gallons, and \$13.50 for amounts thereafter. The provision contains rules so as to prevent members of the same controlled group from receiving the lower rate on more than 100,000 proof gallons of distilled spirits. Importers of distilled spirits are eligible for the lower rates. These reduced rates do not apply to distilled spirits removed after December 31, 2019.

Federal Law (IRC section 5001)

This provision extends the application of the temporary reduced tiered rate for distilled spirits an additional year, making the provisions inapplicable for distilled spirits removed after December 31, 2020.

Effective Date

The provision applies to distilled spirits removed after December 31, 2019.

California Law

The FTB does not administer these types of excise taxes.

Impact on California Revenue

Not applicable.

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<sup>616</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>617</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.

## Subsection (h), Bulk Distilled Spirits

### Background

An excise tax is imposed on all distilled spirits produced in, or imported into, the U.S.<sup>618</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>619</sup>

Distilled spirits are taxed at a rate of \$13.50 per proof gallon.<sup>620</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. Additionally, in order to transfer such spirits in bond without payment of tax, such spirits may not be transferred in containers smaller than one gallon.<sup>621</sup> 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.

Distillers may transfer spirits in approved containers other than bulk containers in bond without payment of tax in the case of distilled spirits transferred in bond after December 31, 2017, and before January 1, 2020.

### Federal Law (IRC section 5212)

This provision would allow distillers to transfer spirits in approved containers other than bulk containers in bond without payment of tax for an additional year in the case of distilled spirits transferred in bond after December 31, 2017, and before January 1, 2021.

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<sup>618</sup> IRC section 5001.

<sup>619</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>620</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>621</sup> IRC section 5212.

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Effective Date

The provision applies to distilled spirits transferred in bond after December 31, 2019.

California Law

The FTB does not administer these types of excise taxes.

Impact on California Revenue

Not applicable.

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Subsection (i), 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.

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>622</sup>

For calendar quarters beginning after the date of the enactment, February 9, 2018, and before January 1, 2020, the IRS permits 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.

New Federal Law (IRC section 5555)

This provision would extend the authorization for taxpayers to employ a unified system for calendar quarter beginning before January 1, 2021.

Effective Date

This provision applies to calendar quarters beginning after December 31, 2019.

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<sup>622</sup> IRC section 5555(a).

California Law

The FTB does not administer these types of excise taxes.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
145	Look-thru Rule for Related Controlled Foreign Corporations

Background

In General

The rules of subpart F<sup>623</sup> require U.S. shareholders with a 10-percent or greater interest in a controlled foreign corporation (CFC) to include certain income of the CFC (referred to as “subpart F income”) as a “deemed” dividend on a current basis for U.S. tax purposes, regardless of whether the income is distributed to the shareholders.

Subpart F income includes foreign base company income. One category of foreign base company income is foreign personal holding company income. For subpart F purposes, foreign personal holding company income generally includes dividends, interest, rents, and royalties, among other types of income. There are several exceptions to these rules. For example, foreign personal holding company income does not include dividends and interest received by a CFC from a related corporation organized and operating in the same foreign country in which the CFC is organized, or rents and royalties received by a CFC from a related corporation for the use of property within the country in which the CFC is organized. Interest, rent, and royalty payments do not qualify for this exclusion to the extent that such payments reduce the subpart F income of the payor. In addition, subpart F income of a CFC does not include any item of income from sources within the U.S. that is effectively connected with the conduct by such CFC of a trade or business within the U.S. (ECI), unless such item is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a tax treaty.

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<sup>623</sup> IRC sections 951-964.

### *The “Look-thru Rule”*

Under the “look-thru rule,”<sup>624</sup> dividends, interest (including factoring income that is treated as equivalent to interest under IRC section 954(c)(1)(E)), rents, and royalties received or accrued by one CFC from a related CFC are not treated as foreign personal holding company income to the extent attributable or properly allocable to income of the payor that is neither subpart F income nor treated as ECI. For this purpose, a related CFC is a CFC that controls or is controlled by the other CFC, or a CFC that is controlled by the same person or persons that control the other CFC. Ownership of more than 50 percent of the CFC’s stock (by vote or value) constitutes control for these purposes.

The Secretary is authorized to prescribe regulations that are necessary or appropriate to carry out the look-thru rule, including such regulations as are necessary or appropriate to prevent the abuse of the purposes of such rule.

### Federal Law (IRC section 954)

In general, a CFC’s interest, dividends, rents, and royalties that is received or accrued from a related person shall not be treated as foreign personal holding company income to the extent attributable or allocable to income of the related person which is neither subpart F income nor income treated as ECI.<sup>625</sup>

This provision extends the look-thru rule to apply to foreign corporation’s taxable years before January 1, 2021<sup>626</sup>.

### Effective Dates

The provision is effective for the CFC’s taxable years beginning after December 31, 2019, and for U.S. shareholder’s taxable years in which such CFC taxable years end.

### California Law (R&TC sections 25110 and 25116)

The CTL does not conform to the subpart F rules under IRC sections 951 through 971. However, relating to taxpayers filing under a water’s-edge election, by reference to the subpart F rules under IRC sections 951 through 971, CTL specifically provides that the amount of a CFC’s income and apportionment factors are included in California taxable income when the CFC has federal subpart F income as determined by multiplying these items by the ratio, the numerator of which is the CFC’s current-year federal subpart F income, as defined by IRC section 952, and the denominator of

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<sup>624</sup> IRC section 954(c)(6).

<sup>625</sup> IRC section 954(c)(6)(A).

<sup>626</sup> IRC section 954(c)(6)(C).



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which is the CFC's current-year federal earnings and profits, as defined by IRC section 964.<sup>627</sup>

Subpart F income, as defined in IRC section 952, includes:

- Insurance income;<sup>628</sup>
- Foreign base company income;<sup>629</sup>
- International boycott income;<sup>630</sup>
- Income from illegal bribes and kickbacks;<sup>631</sup> and
- Foreign country income ineligible for the foreign tax credit.<sup>632</sup>

When applying provisions of the IRC in connection with a water's-edge election that are otherwise not applicable, such as subpart F rules, the federal rules—as applicable for federal purposes—apply.<sup>633</sup> Thus, under California water's-edge rules, the extension of the look-thru rule automatically applies for California purposes.

### Impact on California Revenue

Baseline.

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<u>Section</u>	<u>Section Title</u>
146	Credit for Health Insurance Costs of Eligible Individuals

### Background

Health Coverage Tax Credit (HCTC)

*Eligible Coverage Months*<sup>634</sup>

In the case of an eligible individual, a refundable tax credit is provided for 72.5 percent of the individual's premiums for qualified health insurance of the individual and qualifying family members for each eligible coverage month

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<sup>627</sup> R&TC section 25110.

<sup>628</sup> IRC section 953.

<sup>629</sup> IRC section 954.

<sup>630</sup> IRC sections 952(a)(3) and 999.

<sup>631</sup> IRC section 952(a)(4).

<sup>632</sup> IRC sections 901(j) and 952(a)(5).

<sup>633</sup> R&TC section 25116.

<sup>634</sup> IRC section 35.

beginning in the taxable year.<sup>635</sup> The credit is available only with respect to amounts paid by the individual for qualified health insurance.

Eligibility for the credit is determined on a monthly basis. In general, an eligible coverage month is any month if (1) the month begins before January 1, 2014, and (2) as of the first day of the month, the individual is an eligible individual, is covered by qualified health insurance, the premium for which is paid by the individual, does not have other specified coverage, and is not imprisoned under federal, state, or local authority. In the case of a joint return, the eligibility requirements are met if at least one spouse satisfies the requirements.

#### *Eligible Individuals*<sup>636</sup>

An eligible individual is an individual who is (1) an eligible Trade Adjustment Assistance (TAA) recipient, (2) an eligible alternative TAA recipient or an eligible reemployment TAA recipient, or (3) an eligible Pension Benefit Guaranty Corporation (PBGC) pension recipient. In general, an individual is an eligible TAA recipient for a month if the individual (1) receives for any day of the month a trade readjustment allowance under the Trade Act of 1974 or would be eligible to receive such an allowance but for the requirement that the individual exhaust unemployment benefits before being eligible to receive an allowance, and (2) with respect to such allowance, is covered under a required certification. An individual is an eligible alternative TAA recipient or an eligible reemployment TAA recipient for a month if the individual participates in a certain program under the Trade Act of 1974 and receives a related benefit for the month. Generally, an individual is an eligible PBGC pension recipient for any month if the individual (1) is age 55 or over as of the first day of the month and (2) receives a benefit for the month, any portion of which is paid by the PBGC. A person who may be claimed as a dependent on another person's tax return is not an eligible individual. In addition, an otherwise eligible individual is not eligible for the credit for a month if, as of the first day of the month, the individual has certain specified coverage, such as certain employer-provided coverage or coverage under certain governmental health programs.

#### *Qualified Health Insurance*<sup>637</sup>

Qualified health insurance eligible for the credit is: (1) coverage under a Consolidated Omnibus Budget Reconciliation Act (COBRA) continuation provision;<sup>638</sup> (2) state-based continuation coverage provided by the state under a state law that

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<sup>635</sup> Qualifying family members are the individual's spouse and any dependent for which the individual is entitled to claim a dependency exemption. Any individual who has certain specified coverage is not a qualifying family member.

<sup>636</sup> IRC section 35(c).

<sup>637</sup> IRC section 35(e).

<sup>638</sup> COBRA continuation provision is defined by IRC section 9832(d)(1).

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requires such coverage; (3) coverage offered through a qualified state high-risk pool; (4) coverage under a health insurance program offered to state employees or a comparable program; (5) coverage through an arrangement entered into by a state and a group health plan, an issuer of health insurance coverage, an administrator, or an employer; (6) coverage offered through a state arrangement with a private sector health care coverage purchasing pool; (7) coverage under a state-operated health plan that does not receive any federal financial participation; (8) coverage under a group health plan that is available through the employment of the eligible individual's spouse; (9) coverage under individual health insurance<sup>639</sup> if the eligible individual was covered under individual health insurance during the entire 30-day period that ends on the date the individual became separated from the employment which qualified the individual for the TAA allowance, the benefit for an eligible alternative TAA recipient or an eligible reemployment TAA recipient, or a pension benefit from the PBGC, whichever applies ("30-day requirement"); and (10) coverage under an employee benefit plan funded by a VEBA<sup>640</sup> established pursuant to an order of a bankruptcy court (or by agreement with an authorized representative).<sup>641</sup>

Qualified health insurance does not include any state-based coverage (i.e., coverage described in (2)–(7) in the preceding paragraph) unless the state has elected to have such coverage treated as qualified health insurance and such coverage meets certain consumer-protection requirements.<sup>642</sup> Such state coverage must provide that each qualifying individual is guaranteed enrollment if the individual pays the premium for enrollment or provides a qualified health insurance costs eligibility certificate and pays the remainder of the premium. In addition, the state-based coverage cannot impose any pre-existing condition limitation with respect to qualifying individuals. State-based coverage cannot require a qualifying individual to pay a premium or contribution that is greater than the premium or contribution for a similarly situated individual who is not a qualified individual. Finally, benefits under the state-based coverage must be the same as (or substantially similar to) benefits provided to similarly situated individuals who are not qualifying individuals.

A qualifying individual for this purpose is an eligible individual who seeks to enroll in the state-based coverage and who has aggregate periods of creditable coverage<sup>643</sup> of three months or longer, does not have other specified coverage, and

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<sup>639</sup> For this purpose, "individual health insurance" means any insurance that constitutes medical care offered to individuals other than in connection with a group health plan. Such term does not include federal- or state-based health insurance coverage.

<sup>640</sup> See IRC section 501(c)(9) for the definition of a VEBA.

<sup>641</sup> See 11 U.S.C. section 1114.

<sup>642</sup> For guidance on how a state elects a health program to be qualified health insurance for purposes of the credit, see Rev. Proc. 2004-12, 2004-1 C.B. 528.

<sup>643</sup> Creditable coverage is determined under IRC section 9801(c).

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is not imprisoned. However, state-based coverage that satisfies any or all of the consumer protection requirements for state-based coverage with respect to all eligible individuals is also qualified health insurance for purposes of the HCTC.<sup>644</sup>

Qualified health insurance does not include coverage under a flexible spending or similar arrangement or any insurance if substantially all of the coverage is for excepted benefits.

*Advance Payment of the HCTC*<sup>645</sup>

The credit is available on an advance payment basis by means of payments by the Department of the Treasury (DOT) once a qualified health insurance costs credit eligibility certificate is in effect.<sup>646</sup> In some cases, DOT may also make retroactive payments on behalf of a certified individual for qualified health insurance coverage for eligible coverage months occurring before the first month for which an advance payment is otherwise made on behalf of the individual. With respect to any taxable year, the amount which is allowed as HCTC for an eligible individual for a taxable year is reduced (but not below zero) by the aggregate amount of advance HCTC payments on behalf of the eligible individual for months beginning in the taxable year.

*Premium Assistance Credit*<sup>647</sup>

For taxable years ending after December 31, 2013, a refundable tax credit the “premium assistance credit” (PAC) is provided for eligible individuals and families who purchase health insurance through an American Health Benefit Exchange.<sup>648</sup> The PAC, which is refundable and payable in advance directly to the insurer, subsidizes the purchase of certain health insurance plans through an American Health Benefit Exchange.

The premium assistance credit is available for individuals (single or joint filers) with household incomes between 100 and 400 percent of the federal poverty level (FPL) for the family size involved who are not eligible for certain other health insurance. The PAC amount is generally the lower of (1) the premium for the qualified health plan in which the individual or family enrolls, and (2) the premium for the second lowest cost

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<sup>644</sup> See Q&A–10 of Notice 2005–50, 2005–2 C.B. 14.

<sup>645</sup> IRC section 35(g).

<sup>646</sup> IRC section 7527.

<sup>647</sup> IRC section 35(g)(12).

<sup>648</sup> IRC section 36B.

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silver plan<sup>649</sup> in the rating area where the individual resides, reduced by the individual's or family's share of premiums.

If the premium assistance credit received through advance payment exceeds the amount of premium assistance credit to which the taxpayer is entitled for the taxable year, the liability for the overpayment must be reflected on the taxpayer's income tax return for the taxable year, subject to a limitation on the amount of such liability. For taxpayers with household income below 400 percent of the FPL, the liability for the overpayment for a taxable year is limited to a specific dollar amount which varies depending on the taxpayer's household income as a percentage of the FPL.

Federal Law (IRC section 35)

The provision amends the definition of eligible coverage month for HCTC purposes to include months beginning before January 1, 2021.

Effective Date

The provision is generally effective for coverage months in taxable years beginning after December 31, 2019.

California Law (None)

California does not conform to the HCTC and has its own standalone provisions related to the minimum essential coverage individual mandate, reconciliation of the advanced premium assistance subsidy, and the individual shared responsibility penalty.<sup>650</sup>

Impact on California Revenue

Not applicable.

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<sup>649</sup> A qualified health plan is categorized by level (bronze, silver, gold or platinum), depending on its actuarial value; that is, the percentage of the plan's share of the total costs of benefits under the plan. A silver level plan must have an actuarial value of 70 percent.

<sup>650</sup> Established pursuant to Title 24 (commencing with Section 100700) and Title 25 (commencing with Section 100800) of the Government Code; and the Individual Shared Responsibility Penalty assessed pursuant to Part 32 (commencing with Section 61000) of the R&TC.

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Title II —Disaster Tax Relief

<u>Section</u>	<u>Section Title</u>
201	Definitions

Background

Current federal law provides tax relief for victims of various recent disasters.<sup>651</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 201)

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>652</sup>

The proposals use the terms “qualified disaster area,” “qualified disaster zone,” “qualified disaster,” and “incident period.” As used in the bill, “qualified disaster area” refers to an area with respect to which a major disaster has been declared by the President during the period beginning on January 1, 2018, and ending on the date which is 60 days after the date of enactment of the bill, under section 401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act (the “Stafford Act”), if the incident period of the disaster with respect to which such declaration is made begins on or before the date of the enactment of the bill. However, the “California wildfire disaster area,” as defined in the Bipartisan Budget Act of 2018,<sup>653</sup> is not a qualified disaster area. A “qualified disaster zone” refers to that portion of the applicable “qualified disaster area,” as described above, which has been determined by the President to warrant individual or individual and public assistance from the Federal government under the Stafford Act by reason of the applicable qualified disaster. A “qualified disaster” means, with respect to the applicable qualified disaster area, the disaster by reason of which a major disaster was declared with respect to such area. “Incident period” means, with respect to the applicable qualified disaster, the period specified by the Federal Emergency Management Agency as the period during which such

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<sup>651</sup> See disaster relief provisions in the Disaster Tax Relief and Airport and Airway Extension Act of 2017, P.L. 115-63, September 29, 2017; An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018, P.L. 115-97, December 22, 2017; and the Bipartisan Budget Act of 2018, P.L. 115-123, February 9, 2018.

<sup>652</sup> The June 18, 2019, dated *Description of H.R. 3301, The “Taxpayer Certainty and Disaster Tax Relief Act of 201”* report (JCX-30-19) by the Joint Committee on Taxation includes the definitions that will apply to provisions for temporary tax relief to areas affected by certain major disasters declared in 2018 and some portion of 2019.

<sup>653</sup> P.L. 115-123, section 20102.

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disaster occurred, except that such period shall not be treated as beginning before January 1, 2018, or ending after the date which is 30 days after the date of enactment of this bill.

Effective Date

This provision is effective on December 20, 2019.

California Law (None)

California does not conform to the uncodified federal act provision.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
202	Special Disaster-related Rules for Use of Retirement Funds

Background

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>654</sup>

Distributions from Tax-favored Retirement Plans

A distribution from a qualified retirement plan, a tax-sheltered annuity plan (a "section 403(b) plan"), an eligible deferred compensation plan of a State or local government employer (a "governmental section 457(b) plan"), or an individual retirement arrangement (an "IRA") generally is included in income for the year distributed.<sup>655</sup> These plans are referred to collectively as "eligible retirement plans." In addition, unless an exception applies, a distribution from a qualified retirement plan, a section 403(b) plan, or an IRA received before age 59½ is subject

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<sup>654</sup> The June 18, 2019, dated Description of H.R. 3301, The "Taxpayer Certainty and Disaster Tax Relief Act of 201" report (JCX-30-19) by the Joint Committee on Taxation includes the definitions that will apply to provisions for temporary tax relief to areas affected by certain major disasters declared in 2018 and some portion of 2019, pages 76 and 77.

<sup>655</sup> IRC sections 401(a), 403(a), 403(b), 457(b), and 408. Under IRC section 3405, distributions from these plans are generally subject to income tax withholding unless the recipient elects otherwise. In addition, certain distributions from a qualified retirement plan, an IRC section 403(b) plan, or a governmental IRC section 457(b) plan are subject to mandatory income tax withholding at a 20-percent rate unless the distribution is rolled over.



to a 10-percent additional tax (referred to as the “early withdrawal tax”) on the amount includible in income.<sup>656</sup>

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

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

#### Loans from Tax-favored Retirement Plans

Employer-sponsored retirement plans may provide loans to participants. Unless the loan satisfies certain requirements in both form and operation, the amount of a retirement plan loan is a deemed distribution from the retirement plan. Among the requirements that the loan must satisfy are that the loan amount must not exceed the lesser of 50 percent of the participant’s account balance or \$50,000 (generally taking into account outstanding balances of previous loans), and the loan's terms must provide for a repayment period of not more than five years (except for a loan specifically to purchase a home) and for level amortization of loan payments to be made not less frequently than quarterly.<sup>657</sup> Thus, if an employee stops making payments on a loan before the loan is repaid, a deemed distribution of the outstanding loan balance generally occurs. A deemed distribution of an unpaid loan balance is generally taxed as though an actual distribution occurred, including being subject to a 10-percent early distribution tax, if applicable. A deemed distribution is not eligible for rollover to another eligible retirement plan. Subject to the limit on the amount of loans, which precludes any additional loan that would cause the limit to be exceeded, the rules relating to loans do not limit the number of loans an employee may obtain from a plan.

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<sup>656</sup> IRC section 72(t). Under present law, the 10-percent early withdrawal tax does not apply to distributions from a governmental IRC section 457(b) plan.

<sup>657</sup> IRC section 72(p).

## Tax-favored Retirement Plan Compliance

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

New Federal Law (Uncodified Act Section 202 affecting IRC sections 72, 401, 402, 408, 414, 457, and 3405))

The Joint Committee on Taxation report for P.L. 116-94 states:<sup>658</sup>

### Distributions and Recontributions

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

A “qualified disaster distribution” is any distribution from a qualified retirement plan, section 403(b) plan, or governmental section 457(b) plan, made on or after the first day of the incident period of a qualified disaster and before the date which is 180 days after the date of enactment, to an individual whose principal place of abode at any time during the incident period is located in the qualified disaster area and who has sustained an economic loss by reason of such disaster, regardless of whether a distribution otherwise would be permissible.<sup>659</sup>

A plan is not treated as violating any Code requirement merely because it treats a distribution as a qualified disaster distribution, provided that the aggregate amount of such distributions from plans maintained by the employer and members of the employer’s controlled group or affiliated service group does not exceed \$100,000 for each qualified disaster. The total amount of distributions to an individual from all eligible retirement plans that may be treated as qualified disaster distributions with respect to each qualified disaster is \$100,000. Thus, a plan is not treated as

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<sup>658</sup> The June 18, 2019, dated Description of H.R. 3301, The “Taxpayer Certainty and Disaster Tax Relief Act of 201” report (JCX-30-19) by the Joint Committee on Taxation includes the definitions that will apply to provisions for temporary tax relief to areas affected by certain major disasters declared in 2018 and some portion of 2019, pp. 78-80.

<sup>659</sup> A qualified disaster distribution is subject to income tax withholding unless the recipient elects otherwise. Mandatory 20-percent withholding does not apply.

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violating any Code requirement merely because an individual might receive total distributions in excess of \$100,000, taking into account distributions from plans of other employers or IRAs, or because an individual may have been affected by more than one qualified disaster.

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

Any portion of a qualified disaster distribution may, at any time during the three-year period beginning the day after the date on which the distribution was received, be recontributed to an eligible retirement plan to which a rollover can be made. Any amount recontributed within the three-year period is treated as a rollover and thus is not includible in income. For example, if an individual receives a qualified disaster distribution in 2019, that amount is included in income, generally ratably over the year of the distribution and the following two years, but is not subject to the 10-percent early withdrawal tax. If, in 2021, the amount of the qualified disaster distribution is recontributed to an eligible retirement plan, the individual may file an amended return to claim a refund of the tax attributable to the amount previously included in income. In addition, if, under the ratable inclusion proposal, a portion of the distribution has not yet been included in income at the time of the contribution, the remaining amount is not includible in income.

#### Recontributions of Withdrawals for Purchase of a Home

Any individual who received a qualified disaster distribution<sup>660</sup> during the period beginning on the date which is 180 days before the first day of the incident period of the qualified disaster and ending on the date which is 30 days after the last day of such incident period, which was to be used to purchase or construct a principal residence in a qualified disaster area, but which was not so purchased or constructed on account of the qualified disaster, may, during the "applicable period," make one or more contributions in an aggregate amount not to exceed the amount of such qualified distribution to an eligible retirement plan of which such individual is a beneficiary and to which a rollover contribution of such distribution could be made.<sup>661</sup> The "applicable period" is, in the case of a principal residence in a qualified disaster area

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<sup>660</sup> As described in IRC sections 401(k)(2)(B)(i)(IV), 403(b)(7)(A)(ii)(but only to the extent such distribution relates to financial hardship), 403(b)(11)(B), or 72(t)(2)(F).

<sup>661</sup> Under IRC section 402(c), 403(a)(4), 403(b)(8), or 408(d)(3), as the case may be.

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with respect to any qualified disaster, the period beginning on the first day of the incident period of such qualified disaster and ending on the date which is 180 days after the date of enactment. A plan is not treated as violating any Code requirement merely because it repays such distributions as provided above, provided that the aggregate amount of such repayments from plans maintained by the employer and members of the employer's controlled group or affiliated service group does not exceed \$100,000.

#### Loans

In the case of a "qualified individual" who obtained a loan from a qualified employer plan<sup>662</sup> made during the 180-day period beginning on the date of enactment, in lieu of the permitted maximum loan amount as the lesser of 50 percent of the participant's account balance or \$50,000, the permitted maximum loan amount is the lesser of "the present value of the nonforfeitable accrued benefit of the employee under the plan" (rather than "one-half of the present value of the nonforfeitable accrued benefit of the employee under the plan") or \$100,000, and the loan is not treated as a distribution. For this purpose, a "qualified individual" is an individual whose principal place of abode, during any portion of the incident period of any qualified disaster, was located in the qualified disaster area and who sustained an economic loss by reason of the qualified disaster.

In the case of such a qualified individual (with respect to a qualified disaster) with an outstanding loan (on or after the first day of the incident period of such qualified disaster), from a qualified employer plan, if the due date for any repayment with respect to such a loan<sup>663</sup> occurs during the period beginning on the first day of the incident period of such qualified disaster and ending on the date which is 180 days after the last day of such incident period, the due date is delayed for one year (or, if later, until the date which is 180 days after the date of enactment) and any subsequent repayments will be appropriately adjusted to reflect the delay in any repayment date noted above and any interest accruing during such delay, but the repayment delay is disregarded in determining the 5-year period and the term of the loan.<sup>664</sup>

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<sup>662</sup> As defined under IRC section 72(p)(4).

<sup>663</sup> See IRC section 72(p)(2).

<sup>664</sup> Under IRC section 72(p)(2)(B) or (C).

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## Plan Amendments

A plan amendment made pursuant to the proposal (or a regulation issued thereunder) may be retroactively effective if, in addition to the requirements described below, the amendment is made on or before the last day of the first plan year beginning after January 1, 2020 (or in the case of a governmental plan, January 1, 2022), or a later date prescribed by the Secretary. In addition, the plan is treated as operated in accordance with plan terms during the period beginning with the date the proposal or regulation takes effect (or the date specified by the plan if the amendment is not required by the proposal or regulation) and ending on the last permissible date for the amendment (or, if earlier, the date the amendment is adopted). For an amendment to be retroactively effective, it must apply retroactively for that period, and the plan must be operated in accordance with the amendment during that period.

### Effective Date

The provision is effective on December 20, 2019.

California Law (R&TC sections 17024.5, 17081, 17085, 17085.7, 17501, 17551, and 24601)

Except for the federal changes applicable to retirement plan loans, California automatically conforms to the federal changes with respect to qualified disaster distributions from and re-contributions to a disaster victim's retirement plan.<sup>665</sup> Under the PITL, California generally conforms to retirement plan loan rules as of the specified

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<sup>665</sup> Under R&TC sections 17501 and 24601, 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 sections 17501(b) and 24601(b) specifically provides that federal changes to Part I of Subchapter D of Chapter 1 of Subtitle A of the IRC automatically apply without regard to taxable year to the same extent as applicable for federal income tax purposes (and thus California adopts all changes made to those IRC sections without regard to the specified date contained in R&TC sections 17024.5 and 23051.5). R&TC sections 17551(a) conforms by reference to Subchapter E (IRC sections 441 to 483) of Chapter 1 of Subtitle A of the IRC, relating to accounting periods and methods of accounting. R&TC section 17551(c) specifically provides that federal changes to IRC section 457, relating to deferred compensation plans of state and local governments and tax-exempt organizations, automatically apply without regard to taxable year to the same extent as applicable for federal income tax purposes, except as otherwise provided. R&TC section 17551(c)(2) limits the amount of deferred compensation excludable to the federal amount under IRC section 457 as of January 1, 2010.

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date of January 1, 2015,<sup>666</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>667</sup> However, because under this provision the federal 20-percent withholding is not applicable to qualified disaster distributions 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.<sup>668</sup>

### Impact on California Revenue

Baseline.

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<u>Section</u>	<u>Section Title</u>
203	Employee Retention Credit for Employers Affected by Qualified Disasters

### Background

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, the 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>669</sup>

### New Federal Law (Uncodified Act section 203 affecting IRC section 38)

The provision creates an “employee retention credit” for eligible employers affected by qualified disasters. Eligible employers are generally defined as employers that conducted an active trade or business in a disaster zone at any time during the incident period of the qualified disaster. In general, the 2018 through 2019 qualified disaster employee retention credit is treated as a GBC, and is equal to 40 percent of

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<sup>666</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>667</sup> Unemployment Insurance Code (UIC) section 13028(c)(3).

<sup>668</sup> R&TC section 17085(c).

<sup>669</sup> IRC section 38(a). Also, IRC section 38(b) contains a list of the component credits of the current year GBC.

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qualified wages with respect to each eligible employee of such employer for the taxable year. The amount of qualified wages taken into account for this credit shall not exceed \$6,000 with respect to any employee.

Qualified wages means wages<sup>670</sup> paid or incurred by an eligible employer with respect to an eligible employee at any time on or after the date on which the employer's trade or business first became inoperable at the principal place of employment of the employee and before the earlier of, the date on which such trade or business has resumed significant operations at such principal place of employment, or the date which is 150 days after the last day of the incident period of the qualified disaster.

Effective Date

The provision is effective on December 20, 2019.

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>
204	Other Disaster Related Tax Relief Provisions

*Subsection (a), Temporary Increase in Limitations on Qualified Contributions*

Background

An individual who itemizes can deduct charitable contributions up to 60 percent, 50 percent, 30 percent, or 20 percent of AGI, depending on the type of property contributed and the type of donee.<sup>671</sup> A corporation generally can deduct charitable contributions up to 10 percent of its taxable income.<sup>672</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

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<sup>670</sup> As defined in IRC section 51(c)(1) but without regard to IRC section 3306(b)(2)(B).

<sup>671</sup> IRC section 170(b)(1).

<sup>672</sup> IRC section 170(b)(2).



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ordering rules.<sup>673</sup> For individuals, charitable contributions are deductible only as an itemized deduction.<sup>674</sup>

New Federal Law (Uncodified Act section 204 affecting IRC sections 24, 32, 56, 63, 68, 165, 170, 509, 4966, and 6213)

For qualifying charitable contributions associated with disaster related relief, the provision:

- Provides that such contributions will not be taken into account for purposes of applying AGI and carryover period limitations to other contributions.
- Increased the limitation on the amount of these contributions allowed as deductions.
- Increases the amount of contributions allowed to be carried over.

Qualified contributions must be paid during the period beginning on January 1, 2018, and ending on the date which is 60 days after the date of enactment of this Act (December 20, 2020), 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>675</sup> for relief efforts in one or more qualified 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.

Effective Date

The provision is effective on December 20, 2019.

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

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>676</sup> and as a result, does not conform to the disaster related tax relief provisions related to increased limitations and carryovers for these contributions.

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<sup>673</sup> IRC section 170(d).

<sup>674</sup> Treas. Reg. section 1.170A-1(a).

<sup>675</sup> IRC section 170(b)(1)(A).

<sup>676</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.

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Under the CTL, California does not conform to IRC section 170, but instead has standalone law that is generally similar to federal law allowing corporations a deduction for charitable contributions.<sup>677</sup> There are no similar provisions for the increase in disaster related tax relief contribution limitations and carryovers.

Impact on California Revenue

Not applicable.

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*Subsection (b), Special Rules for Qualified Disaster-Related Personal Casualty Losses*

Background

Under present law, a taxpayer may generally claim a deduction for any loss sustained during the taxable year and not compensated by insurance or otherwise.<sup>678</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>679</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>680</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>681</sup>

New Federal Law (Uncodified Act section 204 affecting IRC sections 24, 32, 56, 63, 68, 165, 170, 509, 4966, and 6213)

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.

In addition, the provision increases the \$100 per-casualty floor to \$500 for qualified disaster-related personal casualty losses.

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<sup>677</sup> R&TC sections 24357 – 24359.1.

<sup>678</sup> IRC section 165.

<sup>679</sup> IRC section 165(h)(1).

<sup>680</sup> IRC section 165(h)(2).

<sup>681</sup> IRC section 165(i).

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The standard deduction is increased by the net disaster loss.

For taxable years ending after December 31, 2018, the increase of the standard deduction does not apply for AMT purposes.

Net disaster loss means the excess of qualified disaster related personal casualty losses over personal casualty gains.<sup>682</sup>

#### Effective Date

The provision is effective on December 20, 2019.

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

California conforms by reference to IRC section 165, relating to losses, as of the specified date of January 1, 2015.<sup>683</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>684</sup> Thus, the California standard deduction is unaffected by qualified disaster-related personal casualty losses.

#### Impact on California Revenue

Not applicable.

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### *Subsection (c), Special Rules for Determining Earned Income*

#### Background

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>685</sup> For 2019, the earned income amount is \$4,220 for taxpayers with no qualifying children, \$6,330 for those with one qualifying child, and \$8,890 for those with two or more qualifying children.

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<sup>682</sup> IRC section 165(h)(3)(A).

<sup>683</sup> R&TC section 17024.5.

<sup>684</sup> R&TC section 17073.5.

<sup>685</sup> IRC section 32.

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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>686</sup> for the year.<sup>687</sup>

Individuals can claim a \$1,000 child tax credit (CTC) for each qualifying child the taxpayer can claim as a dependent.<sup>688</sup> The child must be under 17 and a U.S. citizen or resident alien.<sup>689</sup> The amount of the allowable credit is reduced (not below zero) by \$50 for each \$1,000 (or fraction thereof) of modified AGI above: \$110,000 for joint filers, \$75,000 for unmarried individuals, and \$55,000 for married taxpayers filing separately.<sup>690</sup> To the extent the CTC exceeds the taxpayer's tax liability, the taxpayer is eligible for a refundable credit, in a specified amount.<sup>691</sup>

New Federal Law (Uncodified Act section 204 affecting IRC sections 24, 32, 56, 63, 68, 165, 170, 509, 4966, and 6213)

If the earned income for the applicable taxable year is less than the earned income of a taxpayer for the preceding taxable year, the taxpayer may elect to substitute the earned income of the preceding taxable year for the earned income for the applicable taxable year, for the purposes of the EITC and the CTC.

A qualified individual is one whose principal place of abode at any time during the incident period was located in the qualified disaster zone or in the qualified disaster area but outside the disaster zone and the individual was displaced from their principal place of abode by reason of such qualified disaster.

Effective Date

The provision is effective on December 20, 2019.

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

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>692</sup>

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<sup>686</sup> IRC section 164(f).

<sup>687</sup> IRC section 32(c)(2)(A).

<sup>688</sup> IRC section 24.

<sup>689</sup> IRC section 24(c).

<sup>690</sup> IRC section 24(b).

<sup>691</sup> IRC section 24(d).

<sup>692</sup> R&TC section 17052(c) (4), pursuant to Division 6 (commencing with section 13000) of the UIC.

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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.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
205	Automatic Extension of Filing Deadlines in Case of Certain Taxpayers Affected by Federally Declared Disasters

Background

There has been several areas recently affected by federally declared disasters. The IRC provides taxpayers additional time to file tax returns, pay tax liabilities and take other actions required in order to comply with their tax obligations.<sup>693</sup>

The term “federally declared disaster” means any disaster subsequently determined by the President of the U.S. to warrant assistance by the federal government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act. The term “disaster area” means the area so determined to warrant assistance.<sup>694</sup>

New Federal Law (IRC section 7508A)

Under this provision, a new subsection was added to IRC section 7508A. This new subsection provides that certain taxpayers affected by federally declared disaster areas are allowed a mandatory 60-day filing deadline extension beginning on the earliest incident date specified in the disaster area referred to in the declaration and ending on the date which is 60 days after the latest incident date specified.<sup>695</sup>

Effective Date

This provision applies to federally declared disasters declared after December 20, 2019.

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<sup>693</sup> IRC section 7508A.

<sup>694</sup> IRC section 165(i)(5).

<sup>695</sup> IRC section 7508A(d).

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California Law (R&TC sections 18571 and 19255)

California conforms to IRC section 7508A, relating to postponement of certain tax-related deadlines, as of the “specified date” of January 1, 2015.<sup>696</sup> However, California does not conform to the new federal provision that allows an extension of filing deadlines in case of certain taxpayers affected by federally declared disaster areas.

Impact on California Revenue

Baseline.

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<u>Section</u>	<u>Section Title</u>
206	Modification of the Tax Rate for the Excise Tax on Investment Income of Private Foundations

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>697</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>698</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>699</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>700</sup> A

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<sup>696</sup> R&TC section 18571.

<sup>697</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>698</sup> IRC section 509(a)(1) (referring to IRC sections 170(b)(1)(A)(i) through (iv) for a description of these organizations).

<sup>699</sup> Treas. Reg. 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. Treas. Reg. section 1.170A-9(f)(3).

<sup>700</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

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>701</sup>

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>702</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>703</sup> are subject to a two percent excise tax on their net investment

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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 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 (UBIT) imposed by IRC section 511. IRC section 509(a)(2)(B).

<sup>701</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 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>702</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>703</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



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income for the taxable year. 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>704</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>705</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 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.

New Federal Law (IRC section 4940)

The provision imposes an excise tax on a private foundation for each taxable year equal to 1.39 percent of the net investment income of such foundation for the taxable year. The provision also eliminates the reduction of tax where the foundation meets certain distributions requirements.

Effective Date

The provision is effective for taxable years beginning after December 20, 2019.

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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>704</sup> IRC section 4942(g).

<sup>705</sup> IRC section 4940(e).

California Law (None)

The FTB does not administer these types of excise taxes.

Impact on California Revenue

Not applicable.

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Title III —Other Provisions

<u>Section</u>	<u>Section Title</u>
301	Modification of Income for Purposes of Determining Tax-exempt Status of Certain Mutual or Cooperative Telephone or Electric Companies

Background

An entity must be operated on a cooperative basis in order to be treated as a cooperative (Co-op) 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 Co-op basis are: (1) ownership of the Co-op by persons who patronize the Co-op; and (2) return of earnings to patrons in proportion to their patronage. The IRS requires that Co-ops must operate under the following principles: (1) subordination of capital in control over the Co-op undertaking and in ownership of the financial benefits from ownership; (2) democratic control by the members of the Co-op; (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 Co-op (patronage); and (4) operation at cost (not operating for profit or below cost).

In general, Co-op members are those who participate in the management of the Co-op and who share in patronage capital. As described below, income from the sale of electric energy by a mutual or Co-op telephone or electric company may be member or non-member income to the Co-op, depending on the membership status of the purchaser. A municipal corporation may be a member of a Co-op.

For federal income tax purposes, a Co-op generally computes its income as if it were a taxable corporation, with one exception -- the Co-op may exclude from its taxable income distributions of patronage dividends. In general, patronage dividends are the profits of the Co-op that are rebated to its patrons pursuant to a pre-existing obligation of the Co-op 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 Co-op.

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Except for tax-exempt farmers' Co-ops, Co-op that are subject to the Co-op tax rules of Subchapter T of the Code (IRC section 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 Co-op (IRC section 1382). The availability of such deductions from taxable income has the effect of allowing the Co-op to be treated like a conduit with respect to profits derived from transactions with patrons who are members of the Co-op.

Co-ops that qualify as tax-exempt farmers' Co-ops 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 Co-op, provided the value of transactions with patrons who are not members of the Co-op does not exceed the value of transactions with patrons who are members of the Co-op (IRC section 521).

#### Taxation of Mutual or Co-op Telephone or Electric Companies Exempt from Subchapter T

In general, the Co-op tax rules of Subchapter T apply to any corporation operating on a Co-op basis (except mutual savings banks, insurance companies, other tax-exempt organizations, and certain utilities), including tax-exempt farmers' Co-ops (described in IRC section 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" (IRC section 1381(a)(2)(C)). Instead, mutual or Co-op telephone or electric companies are taxed under rules that were generally applicable to Co-ops prior to the enactment of Subchapter T in 1962. Under these rules, a mutual or Co-op telephone or electric company can exclude patronage dividends from taxable income to the extent of all net income of the Co-op, including net income derived from transactions with patrons who are not members of the Co-op.

#### Tax Exemption of Mutual or Co-op Telephone or Electric Companies

IRC section 501(c)(12) provides an income tax exemption for mutual or Co-op telephone or electric companies if at least 85 percent of the Co-op'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 mutual or Co-op telephone or electric companies also must comply with the fundamental Co-op principles described above in order to qualify for tax exemption under IRC section 501(c)(12).

Mutual or Co-op telephone or electric companies generally are subject to the tax on unrelated trade or business income under IRC section 511.

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New Federal Law (IRC section 501(c)(12))

For purposes of the 85 percent test, mutual or Co-op telephone or electric company income is not taken into account if received or accrued from:<sup>706</sup>

- Any grant, contribution, or assistance provided under the Robert T. Stafford Disaster Relief and Emergency Assistance Act or any similar grant, contribution, or assistance by any local, state, or regional governmental entity for the purpose of relief, recovery, or restoration from, or preparation for, a disaster or emergency,<sup>707</sup> or
- Any grant or contribution by any governmental entity (other than a contribution in aid of construction or any other contribution as a customer or potential customer) the purpose of which is substantially related to providing, constructing, restoring, or relocating electric, communication, broadband, internet, or other utility facilities or services.<sup>708</sup>

Effective Date

The provision is effective for taxable years beginning after December 31, 2017.

California Law (R&TC sections 24405, 24406, 24406.5, and 24406.6)

California does not conform to the tax exemption in IRC Section 501(c)(12) for mutual or Co-op telephone or electric company or the amendments made under the Act. Instead, California has specific rules relating to special deductions allowed to Co-ops.

Co-ops, 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 refunds paid or accrued that meet all of the following conditions:<sup>709</sup>

- 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).

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<sup>706</sup> IRC section 501(c)(12)(J).

<sup>707</sup> IRC section 501(c)(12)(J)(i).

<sup>708</sup> IRC section 501(c)(12)(J)(ii).

<sup>709</sup> R&TC section 24406.

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Regarding patronage refunds of gas producers, each Co-op organization 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 Co-op's organizational documents (articles of incorporation, bylaws or other contract with patrons), dividends on capital stock will not reduce patronage income or prevent the Co-op from being treated as operating on a Co-op basis.

Impact on California Revenue

Not applicable.

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<u>Section</u>	<u>Section Title</u>
302	Repeal of Increase in Unrelated Business Taxable Income for Certain Fringe Benefit Expenses

Background

Tax Exemption for Certain Organizations

IRC section 501(a) exempts certain organizations from federal income tax. Such organizations include: (1) tax-exempt organizations described in IRC section 501(c) (including among others IRC section 501(c)(3) charitable organizations and IRC section 501(c)(4) social welfare organizations); (2) religious and apostolic organizations described in IRC section 501(d); and (3) trusts forming part of a pension, profit-sharing, or stock bonus plan of an employer described in IRC section 401(a).

UBIT In General

The UBIT generally applies to income derived from a trade or business regularly carried on by the organization that is not substantially related to the performance of the organization's tax-exempt functions.<sup>710</sup> An organization that is subject to UBIT and that has \$1,000 or more of gross unrelated business taxable income must report that income on Form 990-T (Exempt Organization Business Income Tax Return).<sup>711</sup>

Most exempt organizations may operate an unrelated trade or business so long as the organization remains primarily engaged in activities that further its exempt purposes. An IRC section 501(c)(3) (charitable) organization, however, may not operate an unrelated trade or business as a substantial part of its activities.<sup>712</sup>

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<sup>710</sup> IRC sections 511-514.

<sup>711</sup> Treas. Reg. section 1.6012.2(e).

<sup>712</sup> Treas. Reg. sections 1.501(c)(3)-1(e).

Therefore, the unrelated trade or business activity of an IRC section 501(c) (3) organization must be insubstantial.

An organization determines its unrelated net business taxable income by subtracting from its gross unrelated business income the deductions directly connected with the unrelated trade or business.<sup>713</sup>

Under regulations, in determining unrelated business taxable income, an organization that operates multiple unrelated trades or businesses aggregates income from all such activities, and subtracts from the aggregate gross income, the aggregate of all deductions.<sup>714</sup> As a result, an organization may use a loss from one unrelated trade or business to offset gain from another, thereby reducing total unrelated business taxable income.

### Organizations Subject to UBIT

Most exempt organizations are subject to UBIT. Specifically, organizations subject to UBIT generally include: (1) organizations exempt from tax under IRC section 501(a), including organizations described in IRC section 501(c) (except for U.S. instrumentalities and certain charitable trusts); (2) qualified pension, profit-sharing, and stock bonus plans described in IRC section 401(a); and (3) certain state colleges and universities.<sup>715</sup>

### Exclusions from Unrelated Business Taxable Income

Certain types of income are specifically exempt from unrelated business taxable income, such as dividends, interest, royalties, and certain rents,<sup>716</sup> unless derived from debt-financed property or from certain 50-percent controlled subsidiaries.<sup>717</sup> Other exemptions from UBIT are provided for activities in which substantially all the work is performed by volunteers, for income from the sale of donated goods, and for certain activities carried on for the convenience of members, students, patients, officers, or employees of a charitable organization.<sup>718</sup> In addition, special UBIT provisions exempt from tax activities of trade shows and state fairs, income from bingo games, and income from the distribution of low-cost items incidental to the solicitation of charitable contributions.<sup>719</sup>

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<sup>713</sup> IRC section 512(a).

<sup>714</sup> Treas. Reg. section 1.512(a)-1(a).

<sup>715</sup> IRC section 511(a)(2).

<sup>716</sup> IRC section 511-514.

<sup>717</sup> IRC section 512(b).

<sup>718</sup> 2019 Instructions Form 990-T.

<sup>719</sup> 2019 Instructions Form 990-T.

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Organizations liable for tax on unrelated business taxable income may be liable for AMT determined after taking into account adjustments and tax preference items.<sup>720</sup>

New Federal Law (IRC section 512)

The provision, amends IRC section 512 (a) to repeal the increase in unrelated business taxable income for certain fringe benefit expenses.

Effective Date

The provision is effective for amounts paid or incurred after December 31, 2017.

California Law (IRC sections 17651 and 23731-23741)

California conforms, under the PITL and the CTL, to the federal rules that apply to unrelated business taxable income under IRC section 512 as of the "specified date" of January 1, 2015, with modifications, but did not conform to the change increasing unrelated business taxable income by the amount of certain fringe benefit expenses for which a deduction is disallowed.

Impact on California Revenue

Not applicable.

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<sup>720</sup> 2019 Instructions Form 990-T.



**EXHIBIT A – 2019 MISCELLANEOUS FEDERAL ACTS IMPACTING THE  
INTERNAL REVENUE CODE NOT REQUIRING A CALIFORNIA RESPONSE**

Public Law 116-91, FUTURE Act.

P.L. 116-91, the “Fostering Undergraduate Talent by Unlocking Resources for Education Act” or the “FUTURE Act,” permanently authorizes the funding for minority-serving institutions of higher education and increases the authorization of appropriations for Pell Grants. It also directs the IRS, upon request of the Department of Education, to disclose to any authorized person, tax return information to determine eligibility for recertifications for income-contingent or income-based repayments of student loans, discharges of loans based on total and permanent disability, and the amount of student financial aid under the Higher Education Act of 1965. The bill also requires Department of Education and the IRS to issue joint reports with certain program information to Congress.

IRC Section	Public Law No.	Act Section No.	133 Stat. Page
6103(L)(13)	116-91	6	1194
6103(L)(13)	116-91	8	1196

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Public Law 116-92, National Defense Authorization Act for Fiscal Year 2020.

P.L. 116-92, the “National Defense Authorization Act for Fiscal Year 2020,” authorizes certain appropriations for fiscal year 2020. It sets forth policies for certain Department of Defense programs and activities, including military personnel strengths, and certain Department of Energy national security programs, including the National Nuclear Security Administration and the Defense Nuclear Facilities Safety Board. In addition, the bill authorizes appropriations for base realignment and closure activities, and maritime matters.

IRC Section	Title No., Subtitle	Act Section No.	S. 1790 Page
501(c)(3)	Title XII, Subtitle G	1265	496
501(c)(3)	Title XVII, Subtitle A	1708	603
501(c)	Title XXXI, Subtitle B	3122	760
1 – 1400Z-2	Title LXXIII, Subtitle A	7312	1080

EXHIBIT A – 2019 MISCELLANEOUS FEDERAL ACTS IMPACTING THE  
INTERNAL REVENUE CODE NOT REQUIRING A CALIFORNIA RESPONSE

Public Law 116-94, Further Consolidations Appropriations Act, 2020.

Public Law 116-94, the “Further Consolidated Appropriations Act, 2020,” provides appropriations for several federal departments and agencies for fiscal year 2020, extends several expiring programs, and addresses a wide range of policy issues throughout the federal government.

IRC Section	Title No., Subtitle	Act Section No.	H.R. 1865 Page
411(d)	Division O, Title VI	601	648
4975	Division P, Title XIII	1302	672
42	Division Q, Title II	207	713
42	Division Q, Title II	208	714
5041	Division Q, Title I	144(j)	702

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**EXHIBIT B – EXPIRING TAX PROVISIONS OF THE CALIFORNIA  
REVENUE AND TAXATION CODE**

California Sunset <sup>721</sup>	California Sections	Federal Section	Federal Sunset	Description
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 <sup>722</sup>
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 <sup>723</sup>
12/31/21	17053.88.5 & 23688.5	N/A	N/A	Agricultural Donations to a Food Bank Credit
12/31/21	18895 - 18898	N/A	N/A	Voluntary Contribution: School Supplies for Homeless Children Fund <sup>724</sup>
12/31/21	18711 - 18714	N/A	N/A	Voluntary Contribution: California Domestic Violence Victims Fund

<sup>721</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.

<sup>722</sup> Under R&TC section 18754.3, this provision may be repealed earlier if the FTB determines the amount of contributions estimated to be received during a calendar year will not equal or exceed the minimum contribution amount for the calendar year.

<sup>723</sup> Under R&TC section 18808, this provision may be repealed earlier if the FTB determines the amount of contributions estimated to be received during a calendar year will not at least equal the minimum contribution amount (\$250,000) for the calendar year.

<sup>724</sup> Under R&TC section 18898, this provision may be inoperative and repealed earlier if the FTB determines the amount of contributions estimated to be received during a calendar year will not at least equal the minimum contribution amount (\$250,000) for the calendar year.

EXHIBIT B – EXPIRING TAX PROVISIONS OF THE CALIFORNIA  
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12/31/22	17053.87 & 23687	N/A	N/A	College Access Tax Credit
12/31/22	18901 - 18901.3	N/A	N/A	Voluntary Contribution: Prevention of Animal Homelessness and Cruelty Voluntary Tax Contribution Fund <sup>725</sup>
12/31/23	17207.14 & 24347.14	N/A	N/A	Election to Take Deduction in Preceding Year for Disaster Loss in 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 <sup>726</sup>
12/31/24	18741 - 18744	N/A	N/A	Voluntary Contribution: Rare and Endangered Species Preservation Voluntary Tax Contribution Program <sup>727</sup>
12/31/24	18745 - 18748	N/A	N/A	Voluntary Contribution: Protect Our Coast and Oceans Voluntary Tax Contribution Fund <sup>728</sup>
12/31/24	18862 - 18864	N/A	N/A	Voluntary Contribution: California Cancer Research Voluntary Tax Contribution Fund <sup>729</sup>

<sup>725</sup> Under R&TC section 18901.3, this provision may be inoperative and repealed earlier if the FTB determines the amount of contributions estimated to be received during a calendar year will not at least equal the minimum contribution amount (\$250,000) for the calendar year.

<sup>726</sup> Under R&TC section 18733, this provision may be inoperative and repealed earlier if the FTB determines the amount of contributions estimated to be received during a calendar year will not at least equal the minimum contribution amount (\$250,000) for the calendar year.

<sup>727</sup> Under R&TC section 18744, this provision may be inoperative and repealed earlier if the FTB determines the amount of contributions estimated to be received during a calendar year will not at least equal the minimum contribution amount (\$250,000) for the calendar year.

<sup>728</sup> Under R&TC section 18748, this provision may be inoperative and repealed earlier if the FTB determines the amount of contributions estimated to be received during a calendar year will not at least equal the minimum contribution amount (\$250,000) for the calendar year.

<sup>729</sup> Under R&TC section 18864, this provision may be inoperative and repealed earlier if the FTB determines the amount of contributions estimated to be received during a calendar year will not at least equal the minimum contribution amount (\$250,000) for the calendar year.

**EXHIBIT B – EXPIRING TAX PROVISIONS OF THE CALIFORNIA  
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12/31/24	18891 - 18894	N/A	N/A	Voluntary Contribution: Keep Arts in Schools Voluntary Tax Contribution Fund <sup>730</sup>
12/31/24	18791 - 18796	N/A	N/A	Voluntary Contribution: California Breast Cancer Research Voluntary Tax Contribution Fund <sup>731</sup>
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 <sup>732</sup>
12/31/24	18902 - 18906	N/A	N/A	Voluntary Contributions: Rape Kit Backlog Voluntary Tax Contribution Fund
12/31/24	18749 - 18749.3	N/A	N/A	Voluntary Contributions: Native California Wildlife Rehabilitation Voluntary Tax Contribution Fund <sup>733</sup>
12/31/25	17053.73 & 23626	N/A	N/A	New Employment Credit <sup>734</sup>
12/31/25	17053.91 & 23691	N/A	N/A	Qualified Rehabilitation Expenditure Credit

<sup>730</sup> Under R&TC section 18894, this provision may be inoperative and repealed earlier if the FTB determines the amount of contributions estimated to be received during a calendar year will not at least equal the minimum contribution amount (\$250,000) for the calendar year.

<sup>731</sup> Under R&TC section 18796, this provision may be inoperative and repealed earlier if the FTB determines the amount of contributions estimated to be received during a calendar year will not at least equal the minimum contribution amount (\$250,000) for the calendar year.

<sup>732</sup> Under R&TC section 18766, this provision may be inoperative and repealed earlier if the FTB determines the amount of contributions estimated to be received during a calendar year will not at least equal the minimum contribution amount (\$250,000) for the calendar year.

<sup>733</sup> Under R&TC section 18749.3, this provision may be inoperative and repealed earlier if the FTB determines the amount of contributions estimated to be received during a calendar year will not at least equal the minimum contribution amount (\$250,000) for the calendar year.

<sup>734</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

12/31/25	18851 - 18855	N/A	N/A	Voluntary Contribution: Emergency Food for Families Voluntary Tax Contribution Fund <sup>735</sup>
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 <sup>736</sup>
12/31/25	18910 - 18913	N/A	N/A	Voluntary Contribution: Schools Not Prisons Voluntary Tax Contribution Fund <sup>737</sup>
12/31/25	18857 - 18857.3	N/A	N/A	Voluntary Contributions: National Alliance on Mental Illness California Voluntary Tax Contribution Fund <sup>738</sup>
12/31/26	18914 - 18917	N/A	N/A	Voluntary Contributions: Suicide Prevention Voluntary Tax Contribution Fund <sup>739</sup>
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 Hiring Credit

<sup>735</sup> Under R&TC section 18855, this provision may be inoperative and repealed earlier if the FTB determines the amount of contributions estimated to be received during a calendar year will not at least equal the minimum contribution amount (\$250,000) for the calendar year.

<sup>736</sup> Under R&TC section 18907.4, this provision may be inoperative and repealed earlier if the FTB determines the amount of contributions estimated to be received during a calendar year will not at least equal the minimum contribution amount (\$250,000) for the calendar year.

<sup>737</sup> Under R&TC section 18913, this provision may be inoperative and repealed earlier if the FTB determines the amount of contributions estimated to be received during a calendar year will not at least equal the minimum contribution amount (\$250,000) for the calendar year.

<sup>738</sup> Under R&TC section 18857.3, this provision may be inoperative and repealed earlier if the FTB determines the amount of contributions estimated to be received during a calendar year will not at least equal the minimum contribution amount (\$250,000) for the calendar year.

<sup>739</sup> Under R&TC section 18917, this provision may be inoperative and repealed earlier if the FTB determines the amount of contributions estimated to be received during a calendar year will not at least equal the minimum contribution amount (\$250,000) for the calendar year.

EXHIBIT C – REVENUE TABLES

Table 1 – FUTURE Act (Public Law 116-91)					
Act Section	Provision	2019-20	2020-21	2021-22	2022-23
3	Secure Disclosure of Tax-return Information to Carry Out the Higher Education Act of 1965	N/A	N/A	N/A	N/A

Table 2 – National Defense Authorization Act for Fiscal Year 2020 (Public Law 116-92)					
Act Section	Provision	2019-20	2020-21	2021-22	2022-23
1122	Prohibition on Criminal History Inquiries Prior to Conditional Offer for Federal Employment	N/A	Negligible	Negligible	Negligible

Table 3 – Further Consolidations Appropriations Act, 2020 (Public Law 116-94)					
Act Section	Provision	2019-20	2020-21	2021-22	2022-23
Div. J, Title IX - 901	Special Rules for Certain Monthly Workers' Compensation Payments and Other Payments for Department of State Personnel under Chief of Mission Authority	N/A	Negligible	Negligible	Negligible
Div. M - 104	Reduction in Minimum Age for Allowable In-service Distributions	Baseline	Baseline	Baseline	Baseline
Div. N, Subtitle A - 104	Extension of Appropriations to the Patient-centered Outcomes Research Trust Fund; Extension of Certain Health Insurance Fees	Defer	Defer	Defer	Defer
Div. N, Subtitle E - 501	Repeal of Medical Device Excise Tax	Defer	Defer	Defer	Defer



**EXHIBIT C - REVENUE TABLES**

Act Section	Provision	2019-220	2020-21	2021-22	2022-23
Div. N, Subtitle E - 502	Repeal of Annual Fee on Health Insurance Providers (Insurance Companies)	Defer	Defer	Defer	Defer
Div. N, Subtitle E - 502	Repeal of Annual Fee on Health Insurance Providers (Nonadmitted Insurance Policyholders)	N/A	N/A	N/A	N/A
Div. N, Subtitle E - 503	Repeal of Excise Tax on High Cost Employer-sponsored Health Coverage	Defer	Defer	Defer	Defer
Div. O, Title I - 101	Multiple Employer Plans; Pooled Employer Plans	Baseline	Baseline	Baseline	Baseline
Div. O, Title I - 102	Increase in 10 Percent Cap for Automatic Enrollment Safe Harbor After 1st Plan Year	Baseline	Baseline	Baseline	Baseline
Div. O, Title I - 103	Rules Relating to Election of Safe Harbor 401(K) Status	Baseline	Baseline	Baseline	Baseline
Div. O, Title I - 104	Increase in Credit Limitation for Small Employer Pension Plan Startup Costs	N/A	N/A	N/A	N/A
Div. O, Title I - 105	Small Employer Automatic Enrollment Credit	N/A	N/A	N/A	N/A
Div. O, Title I - 106	Certain Taxable Non-tuition Fellowship and Stipend Payments Treated as Compensation for IRA Purposes	Baseline	Baseline	Baseline	Baseline
Div. O, Title I - 107	Repeal Of Maximum Age For Traditional Ira Contributions	-\$600,000	-\$450,000	\$600,000	-\$700,000
Div. O, Title I - 108	Qualified Employer Plans Prohibited from Making Loans Through Credit Cards and Other Similar Arrangements	N/A	Negligible	Negligible	Negligible
Div. O, Title I - 109	Portability of Lifetime Income Options	N/A	N/A	N/A	N/A
Div. O, Title I - 110	Treatment of Custodial Accounts on Termination of Section 403(B) Plans	N/A	N/A	N/A	N/A
Div. O, Title I - 111	Clarification of Retirement Income Account Rules Relating to Church Controlled Organizations	N/A	N/A	N/A	N/A

**EXHIBIT C - REVENUE TABLES**

Act Section	Provision	2019-20	2020-21	2021-22	2022-23
Div. O, Title I - 112	Qualified Cash or Deferred Arrangements Must Allow Long-term Employees Working More Than 500 But Less Than 1,000 Hours Per Year to Participate	Baseline	Baseline	Baseline	Baseline
Div. O, Title I - 113	Penalty-free Withdrawals From Retirement Plans for Individuals in Case of Birth of Child or Adoption	Baseline	Baseline	Baseline	Baseline
Div. O, Title I - 114	Increase in Age for Required Beginning Date for Mandatory Distributions	Baseline	Baseline	Baseline	Baseline
Div. O, Title I - 115	Special Rules for Minimum Funding Standards for Community Newspaper Plans	Baseline	Baseline	Baseline	Baseline
Div. O, Title I - 116	Treating Excluded Difficulty of Care Payments as Compensation for Determining Retirement Contribution Limitations	Baseline	Baseline	Baseline	Baseline
Div. O, Title II - 201	Plan Adopted by Filing Due Date for Year May be Treated as in Effect As of Close of Year	Baseline	Baseline	Baseline	Baseline
Div. O, Title II - 202	Combined Annual Report for Group of Plans	N/A	N/A	N/A	N/A
Div. O, Title II - 205	Modification of Nondiscrimination Rules to Protect Older, Longer Service Participants	Baseline	Baseline	Baseline	Baseline
Div. O, Title III - 301	Benefits Provided To Volunteer Firefighters and Emergency Medical Responders	N/A	-\$1,600,000	N/A	N/A
Div. O, Title III - 302	Expansion of Section 529 Plans	N/A	-\$1,600,000	-\$900,000	\$1,000,000
Div. O, Title IV - 401	Modification of Required Distribution Rules for Designated Beneficiaries	Baseline	Baseline	Baseline	Baseline
Div. O, Title IV - 402	Increase in Penalty for Failure to File	N/A	N/A	N/A	N/A
Div. O, Title IV - 403	Increased Penalties for Failure to File Retirement Plan Returns	N/A	N/A	N/A	N/A
Div. O, Title IV - 404	Increase Information Sharing to Administer Excise Taxes	N/A	N/A	N/A	N/A

**EXHIBIT C - REVENUE TABLES**

Act Section	Provision	2019-20	2020-21	2021-22	2022-23
Div. O, Title V – 501	Modification of Rules Relating to the Taxation of Unearned Income of Certain Children	N/A	-\$80,000	-\$50,000	-\$60,000
Div. Q, Title I, Subtitle A - 101	Exclusion from Gross Income of Discharge of Qualified Principal Residence Indebtedness	N/A	-\$25,000,000	-\$2,000,000	N/A
Div. Q, Title I, Subtitle A - 102	Treatment of Mortgage Insurance Premiums as Qualified Residence Interest	N/A	N/A	N/A	N/A
Div. Q, Title I, Subtitle A - 103	Reduction in Medical Expense Deduction Floor	N/A	\$60,000	N/A	N/A
Div. Q, Title I, Subtitle A - 104	Deduction of Qualified Tuition and Related Expenses	N/A	N/A	N/A	N/A
Div. Q, Title I, Subtitle A - 105	Black Lung Disability Trust Fund Excise Tax	Defer	Defer	Defer	Defer
Div. Q, Title I, Subtitle B - 111	Indian Employment Credit	N/A	N/A	N/A	N/A
Div. Q, Title I, Subtitle B – 112	Railroad Track Maintenance Credit	N/A	N/A	N/A	N/A
Div. Q, Title I, Subtitle B – 113	Mine Rescue Team Training Credit	N/A	N/A	N/A	N/A
Div. Q, Title I, Subtitle B – 114	Classification of Certain Race Horses as 3-Year Property	N/A	N/A	N/A	N/A
Div. Q, Title I, Subtitle B – 115	7-Year Recovery Period for Motorsports Entertainment Complexes	N/A	N/A	N/A	N/A
Div. Q, Title I, Subtitle B – 116	Accelerated Depreciation for Business Property on Indian Reservations	N/A	N/A	N/A	N/A
Div. Q, Title I, Subtitle B – 117	Expensing Rules for Certain Productions	N/A	N/A	N/A	N/A
Div. Q, Title I, Subtitle B – 118	Empowerment Zone Tax Incentives	N/A	N/A	N/A	N/A
Div. Q, Title I, Subtitle B - 119	American Samoa Economic Development Credit	N/A	N/A	N/A	N/A
Div. Q, Title I, Subtitle C - 121	Biodiesel and Renewable Diesel	N/A	N/A	N/A	N/A
Div. Q, Title I, Subtitle C - 122	Second Generation Biofuel Producer Credit	N/A	N/A	N/A	N/A
Div. Q, Title I, Subtitle C - 123	Nonbusiness Energy Property	N/A	N/A	N/A	N/A

EXHIBIT C - REVENUE TABLES

Act Section	Provision	2019-20	2020-21	2021-22	2022-23
Div. Q, Title I, Subtitle C - 124	Qualified Fuel Cell Motor Vehicles	N/A	N/A	N/A	N/A
Div. Q, Title I, Subtitle C - 125	Alternative Fuel Refueling Property Credit	N/A	N/A	N/A	N/A
Div. Q, Title I, Subtitle C - 126	2-Wheeled Plug-in Electric Vehicle Credit	N/A	N/A	N/A	N/A
Div. Q, Title I, Subtitle C - 127	Credit for Electricity Produced from Certain Renewable	N/A	N/A	N/A	N/A
Div. Q, Title I, Subtitle C - 128	Production Credit for Indian Coal Facilities	N/A	N/A	N/A	N/A
Div. Q, Title I, Subtitle C - 129	Energy Efficient Homes Credit	N/A	N/A	N/A	N/A
Div. Q, Title I, Subtitle C - 130	Special Allowance for Second Generation Biofuel Plant Property	N/A	N/A	N/A	N/A
Div. Q, Title I, Subtitle C - 131	Energy Efficient Commercial Buildings Deduction	N/A	N/A	N/A	N/A
Div. Q, Title I, Subtitle C - 132	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
Div. Q, Title I, Subtitle C - 133	Extension and Clarification of Excise Tax Credits Relating to Alternative Fuels	N/A	N/A	N/A	N/A
Div. Q, Title I, Subtitle C - 134	Oil Spill Liability Trust Fund Rate	Defer	Defer	Defer	Defer
Div. Q, Title I, Subtitle D - 141	New Markets Tax Credit	N/A	N/A	N/A	N/A
Div. Q, Title I, Subtitle D - 142	Employer Credit For Paid Family And Medical Leave	N/A	N/A	N/A	N/A
Div. Q, Title I, Subtitle D - 143	Work Opportunity Tax Credit	N/A	N/A	N/A	N/A
Div. Q, Title I, Subtitle D - 144	Certain Provisions Related to Beer, Wine, and Distilled Spirits	N/A	-\$900,000	\$100,000	\$200,000
Div. Q, Title I, Subtitle D - 145	Look-thru Rule for Related Controlled Foreign Corporations	Baseline	Baseline	Baseline	Baseline
Div. Q, Title I, Subtitle D - 146	Credit for Health Insurance Costs of Eligible Individuals	N/A	N/A	N/A	N/A
Div. Q, Title II - 201	Definitions	N/A	N/A	N/A	N/A
Div. Q, Title II - 202	Special Disaster-related Rules for Use of Retirement Funds	Baseline	Baseline	Baseline	Baseline
Div. Q, Title II - 203	Employee Retention Credit for Employers Affected by Qualified Disasters	N/A	N/A	N/A	N/A

EXHIBIT C - REVENUE TABLES

Act Section	Provision	2019-20	2020-21	2021-22	2022-23
Div. Q, Title II - 204	Other Disaster-related Tax Relief Provisions	N/A	N/A	N/A	N/A
Div. Q, Title II - 205	Automatic Extension of Filing Deadlines in Case of Certain Taxpayers Affected by Federally Declared Disasters	Baseline	Baseline	Baseline	Baseline
Div. Q, Title II - 206	Modification of the Tax Rate for the Excise Tax on Investment Income of Private Foundations	N/A	N/A	N/A	N/A
Div. Q, Title III - 301	Modification of Income for Purposes of Determining Tax-Exempt Status of Certain Mutual or Cooperative Telephone or Electric Companies	N/A	N/A	N/A	N/A
Div. Q, Title III - 302	Repeal of Increase in Unrelated Business Taxable Income for Certain Fringe Benefit Expenses	N/A	N/A	N/A	N/A