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Federal Tax Conformity - 1987: A Comparison of Prior and New Federal and State Personal and Corporation Taxes

Senate Committee on Revenue and Taxation

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FEDERAL TAX CONFORMITY——1987

A Comparison of Prior and New Federal and State Personal and Corporation Taxes

Senate Bill 572 (Garamendi)
and
Assembly Bill 53 (Klehs)



Senate Committee on Revenue and Taxation
John Garamendi, Chairman
January 1988

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January 1988

This report is a summary of the actions which the Legislature took last year to conform California's personal and corporation income taxes with the massive federal tax reforms of 1986.

The legislation consisted of two bills: my Senate Bill 572 and Assemblymember Johan Klehs' Assembly Bill 53. These two conformity bills were the product of a two-house conference committee, jointly chaired by Mr. Klehs and me, and comprising Senators Bill Lockyer and Rebecca Morgan, and Assemblymembers Elihu Harris and Dennis Brown.

The primary objective of the 1987 conformity effort was to produce a California tax system which is as simple as possible for California taxpayers to deal with. To this end the bills require that the tax forms be designed around the federal returns, and that most of the numbers which are prepared for federal purposes are also used for the state return, with as few adjustments as possible.

In addition, the bills adopt several areas of federal law with which our law has not heretofore conformed, including the ability to carryover net operating losses into future years and conformity with the federal "Subchapter S" provisions for small business corporations.

Finally, the conformity package was designed to be "revenue neutral," neither increasing nor decreasing tax revenue, nor shifting tax burdens from individuals to corporations as the federal reforms did.

The attached document was prepared by Martin Helmke and Anne Maitland of the Senate Revenue and Taxation Committee staff, and by Ellen Worcester and Debbie Hale of the Assembly Revenue and Taxation Committee staff.


JOHN GARAMENDI

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FEDERAL TAX CONFORMITY -- 1987

A COMPARISON OF
PRIOR AND NEW FEDERAL AND STATE
PERSONAL AND CORPORATION TAXES

Senate Bill 572 (Garamendi)

and

Assembly Bill 53 (Klehs)

Senate Revenue and Taxation Committee

John Garamendi, Chairman

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PROVISIONS AFFECTING INDIVIDUALS

INDIVIDUAL TAX RATES

PRIOR FEDERAL LAW. Individuals were taxed in 15 brackets at rates from 11 percent to 50 percent, depending upon filing status and taxable income.

NEW FEDERAL LAW. There are two basic tax rates, 15 percent and 28 percent. However, the benefit of the 15 percent rate is phased out for those with high taxable incomes. These rates will be fully effective in 1988. In 1987, transition rates apply. The table below illustrates the new federal rates which will apply to taxable income in 1987 and in 1988.

Rates	Joint Returns	Heads of Household	Single Individuals
<u>1987</u>			
11%	0- 3,000	0- 2,500	0- 1,800
15	3,000- 28,000	2,500- 23,000	1,800- 16,800
28	28,000- 45,000	23,000- 38,000	16,800- 27,000
35	45,000- 90,000	38,000- 80,000	27,000- 54,000
38.5	Above 90,000	Above 80,000	Above 54,000
<u>1988</u>			
15%	Up to 29,750	Up to 23,900	Up to 17,850
28	29,750- 71,900	23,000- 61,650	17,850- 43,150
33	71,900-149,250	61,650-123,790	43,150- 89,560
28	Above 149,250	Above 123,790	Above 89,560

PRIOR CALIFORNIA LAW. There were 11 tax rates, ranging from 1 to 11 percent. In 1986, the maximum 11 percent rate was paid by joint filers with taxable incomes of at least \$57,580, by heads of households with taxable incomes of \$34,880 or more, and by single individuals with taxable incomes of \$28,790 or more.

New California Law The brackets range from 1 to 9.3 percent. The maximum rate is paid by joint filers with taxable incomes of more than \$47,900, and by single filers with incomes greater than \$23,950. Bracket indexing is retained by the bill, so that in future years the brackets will continue to

widen. For 1987 these brackets and rates for joint filers are:

Taxable Income	Rate
0 - 7,300	1%
7,300 - 17,300	2%
17,300 - 27,300	4%
27,300 - 37,900	6%
37,900 - 47,900	8%
47,900 & Over	9.3%

STANDARD DEDUCTION

PRIOR FEDERAL LAW. The lowest bracket in the tax rate schedules has a tax rate of zero. The amount in the bracket for each schedule is called the zero-bracket amount. It is, in effect, a deduction since that amount is not taxed. For 1986, the zero bracket amount is \$3,670 for married individuals filing joint returns and \$2,480 for single individuals and heads of households.

NEW FEDERAL LAW. The zero bracket amount is eliminated and replaced with a standard deduction. For 1987, the standard deduction is \$3,760 for married individuals and \$2,540 for single individuals and heads of households. In 1988, the standard deduction will be \$5,000 for married couples filing joint returns and \$4,400 for single individuals and heads of households. Elderly and blind taxpayers will be entitled to an extra standard deduction.

PRIOR CALIFORNIA LAW. The zero bracket amount for 1987 would have been \$3,420 for married individuals filing joint returns and heads of households and \$1,710 for single individuals.

New California Law. The zero bracket amount is repealed and replaced with a standard deduction. The standard deduction is \$3,760 for joint returns and \$1,880 for single and separate returns. No extra standard deductions are provided for aged or blind taxpayers, because the bill grants a separate, additional \$51 exemption credit for aged and blind taxpayers. The standard deduction will be indexed annually, as under present law.

EXEMPTIONS

PRIOR FEDERAL LAW. An exemption of income is available for each taxpayer, spouse, and dependent. In 1986, the value of each exemption is \$1,080. An additional exemption is allowed if the taxpayer is blind or disabled.

NEW FEDERAL LAW. The personal exemption is increased to \$1,900 in 1987, \$1,950 in 1988, and \$2,000 in 1989. The additional exemptions for blind and disabled individuals are eliminated and replaced with an increased standard deduction. Persons who could be claimed as dependents on another tax return are not eligible for the personal exemption.

PRIOR CALIFORNIA LAW. Exemptions for taxpayers, spouses, and dependents are provided as tax credits, rather than as deductions. In 1986, the credit for married individuals and heads of households was \$86 and \$43 for single individuals. There was a \$14 credit for each dependent. Blind individuals received an additional \$14 credit.

California did not provide an exemption credit for the elderly, but did exclude \$1,000 from adjusted gross incomes of up to \$25,000. This exclusion was phased out between \$25,000 and \$27,000.

New California Law. Personal and dependent credits are continued under the new law. For 1987, the personal credit is increased to \$51 (\$102 for joint and head of household returns). The dependent credit is increased to equal the personal credit of \$51 each. In addition, the present \$1,000 exemption for seniors is converted to a credit of \$51. For 1988, these credits are increased to \$52, and are indexed annually thereafter. New law conforms to the federal rule denying the personal credit for individuals claimed as a dependent on another tax return.

EXCLUSIONS FROM INCOME

PRIOR FEDERAL LAW. Adjustments to income are made for the following:

- Unemployment compensation benefits are taxed if adjusted gross income exceeded \$12,000 (\$18,000 for joint filers).
- \$100 (\$200 for joint filers) of dividends are excluded from income.
- Employee business expenses for travel, meals, and lodging are excluded from income if they were not reimbursed by the employer.
- Moving expenses were allowed as an "above-the-line" deduction.

NEW FEDERAL LAW. Adjustments to income are made for the following:

- All unemployment compensation benefits are taxable.
- The dividend exclusion is repealed.

- A deduction for employee business expenses replaces the exclusion from gross income (see below).
- Moving expenses are now deductible for itemizers only.

PRIOR CALIFORNIA LAW. State law differed from prior federal in the following areas:

- Unemployment benefits and Social Security income were not included in income.
- There was no dividend exclusion.
- Lottery winnings were exempt.
- There was a \$1000 exclusion of military income for those on active duty status. There was also a \$1000 exclusion for military retirement and reserve pay, reduced by 50 cents for each dollar of adjusted gross income over \$25,000.

New California Law. Unemployment and social security benefits and lottery winnings continue to be exempt. The military exclusion is converted to an equivalent tax credit of up to \$40 for any person who received active or reserve military pay or a military pension during the year, provided adjusted gross income does not exceed \$27,000. Treatment of employee business expenses and moving expenses conforms with the federal law.

INCOME AVERAGING

PRIOR FEDERAL LAW. Taxpayers whose incomes fluctuate greatly from year to year receive tax relief if income for the current year is \$3000 greater than 140 percent of the average income for the preceding three years.

NEW FEDERAL LAW. This provision is repealed.

PRIOR CALIFORNIA LAW. State law was similar to prior federal law, except that the current year income must have been \$3000 greater than 133 1/3 percent of the average income for the preceding four years.

New California Law conforms with federal law by repealing the income averaging provision.

DEDUCTIONS

PRIOR FEDERAL LAW. Deductions were allowed for the following types of expenses:

- charitable contributions of up to 50 percent of adjusted gross income

- medical expenses which exceeded 5 percent of adjusted gross income
- interest payments
- state and local income, sales and property taxes
- expenses related to earning income, including union dues, professional journals, tax return preparation
- married individuals who both worked were allowed to deduct 10 percent of the lower salary. The maximum deduction was \$3,000.

NEW FEDERAL LAW. The following changes were made:

- charitable contribution deductions for non-itemizers are eliminated
- medical deductions are allowed only for expenses which exceed 7.5 percent of adjusted gross income
- interest on principal and second home loans is deductible up to the amount of purchase price plus improvements, educational, or medical expenses. Deduction for consumer interest is phased out: in 1987, 65 percent is deductible; in 1988, 40 percent; in 1989, 20 percent, and in 1990, 10 percent.
- sales taxes are no longer deductible
- employee business expenses and miscellaneous deductions are allowed only for amounts which exceed 2 percent of AGI
- the two-earner deduction is repealed.

PRIOR CALIFORNIA LAW. The State conformed with prior federal law with the following exceptions:

- charitable contributions were limited to 20 percent of adjusted gross income.
- state income tax was not deductible
- there was no two-earner deduction for married individuals.

New California Law conforms with new federal deduction limits, except that no deduction is allowed for state income tax. Charitable deductions are limited to no more than 50% of adjusted gross income (in conformity with federal law).

PASSIVE LOSSES

PRIOR FEDERAL LAW. Losses from passive trade or business activity could be deducted against other income. A passive activity is one in which the taxpayer is not involved on a regular, continuous, and substantial basis.

NEW FEDERAL LAW. Passive losses can only offset passive income, not wage, salary or portfolio income. Rental losses of up to \$25,000 may be offset against other income only if the taxpayer actively participates in the management of the rental activity and has at least a 10 percent interest in it.

This \$25,000 allowance is phased out for taxpayers with incomes between \$100,000 and \$150,000. For those with low-income housing or rehabilitation credits, the phase-out is between \$200,000 and \$250,000.

PRIOR CALIFORNIA LAW. The State conformed with prior federal law.

New California Law conforms with the new federal law.

AT-RISK RULES

PRIOR FEDERAL LAW. Except for real estate, there was a limit on the amount of losses from business and income-producing activity which could be taken against income. The loss deduction was equal to the amount the taxpayer was "at risk" -- the taxpayer's cash contributions, the adjusted basis of other property contributed to the activity, and the amount borrowed for use in the activity for which the taxpayer is personally liable.

NEW FEDERAL LAW. The at-risk rules are extended to real estate. Nonrecourse financing is treated as an amount at risk. For related persons, the terms of the loan must be commercially reasonable and substantially the same terms as those for unrelated persons.

PRIOR CALIFORNIA LAW. The State conformed with prior federal law.

New California Law conforms with the new federal at-risk rules, and their application to real estate investments.

INVESTMENT INTEREST EXPENSE

PRIOR FEDERAL LAW. For individual taxpayers, a deduction may be taken for the interest on debt incurred to purchase property held for investment. This deduction is limited to \$10,000 annually plus investment income and certain deductible expenditures. If investment interest exceeds the \$10,000 limit, it can be carried over.

NEW FEDERAL LAW. The deduction of investment interest is limited to the amount of net investment income (after expenses are deducted).

These provisions are phased in from 1987 through 1990.

PRIOR CALIFORNIA LAW. The State conformed with prior federal law.

New California Law conforms with the new federal law.

CAPITAL GAINS

PRIOR FEDERAL LAW. 60 percent of gains from assets held 6 months or longer is excluded from taxation, resulting in a maximum tax rate of 20 percent for capital gains.

NEW FEDERAL LAW. Capital gains are taxed as ordinary income with a maximum rate of 28 percent.

PRIOR CALIFORNIA LAW. All of the gain on assets held for less than 1 year was taxed as ordinary income. 35 percent of gain was excluded from the sale of assets held 1-5 years and 50 percent of gain was excluded from the sale of assets held 5 or more years.

None of the gain from the sale of qualified small business stock was taxed if it had been held for 3 or more years.

New California Law conforms with the new federal treatment of capital gains. However, from 1987 to 1991, gains from rental residential property and farms will be eligible for a tax credit of up to 4 1/2%. The small business stock capital gain provision was repealed as of October 1987.

PREFERENCE TAX / ALTERNATIVE MINIMUM TAX

PRIOR FEDERAL LAW. An alternative minimum tax (AMT) must be paid if it exceeds the amount of regular income tax due. AMT is based on alternative minimum taxable income, which includes adjusted gross income and tax preferences, less certain exemptions. (Tax preferences include excess accelerated depreciation on property, excluded dividends, excess percentage depletion allowances and intangible drilling costs, and excess long-term capital gains.) The alternative minimum tax rate of 20 percent is applied to the amount by which alternative minimum taxable income exceeds \$40,000 for joint returns or \$30,000 for single returns.

NEW FEDERAL LAW. The tax rate is increased to 21 percent and the types of tax preferences included in alternative minimum taxable income have been increased.

PRIOR CALIFORNIA LAW. There was an add-on tax on certain types of income (tax preference items) in addition to regular personal income tax. The tax rate, after exemptions, ranged from 1/2 percent to 5 1/2 percent of preference income. The maximum preference tax rate was paid by joint filers with \$30,000 of preference income, by heads of household with

\$15,500 of preference income, and by single filers with \$15,000 preference income.

New California Law conforms with the new federal alternative minimum tax, at a 7% rate.

PENSION PROVISIONS

INDIVIDUAL RETIREMENT ACCOUNTS

PRIOR FEDERAL LAW. The maximum contribution was \$2,000 for individuals. For married couples, the maximum contribution was \$2,250 if one spouse worked and \$4,000 if both spouses worked.

NEW FEDERAL LAW. There was no change in law for a single individual (or married individual filing separately) who is not covered by a pension plan. If an individual is covered by a pension plan, then the IRA deduction limit is phased out between \$25,000 and \$35,000 of adjusted gross income for single filers, between \$40,000 and \$50,000 for married couples filing a joint return, and between 0 and \$10,000 for married couples filing separate returns. For a married couple filing a joint return, the phaseout applies to both individuals even if only one is an active participant in a pension plan.

PRIOR CALIFORNIA LAW. The maximum deduction an individual may take was \$1,500 (plus \$250 for a non-employed spouse). No deduction was allowed if an individual was an active participant in a pension plan.

New California Law conforms with the new federal IRA provisions.

401(k) PLANS

PRIOR FEDERAL LAW. Employees may defer salary in an employer's profit-sharing plan. Maximum annual deferrals are 20 percent of salary or \$30,000, whichever is less.

NEW FEDERAL LAW. Maximum deferral is 20 percent of salary or \$7,000, whichever is less.

PRIOR CALIFORNIA LAW. The maximum deferral amount was \$30,000.

New California Law conforms with the new federal 401(k) provisions.

PENSION DISTRIBUTIONS

PRIOR FEDERAL LAW. Lump sums from pension and profit-sharing plans are taxed using 10-year averaging. Capital gains treatment is available for contributions made prior to 1974.

There is a special recovery rule for employees who had made taxable contributions to a pension plan. (Generally government employees.) The first withdrawals during retirement are deemed to be all from the employee's contributions and were thus tax-free. This provision applied to employees all of whose contributions would be withdrawn within three years of retirement (the so-called "three-year" rule). Thereafter, all withdrawals were fully taxed.

NEW FEDERAL LAW. Lump sum withdrawals are subject to 5-year averaging. There is a six-year phase-out of the capital gain treatment for pre-1974 contributions.

The "three-year rule" on taxation of employee contributions to a pension plan is repealed retroactively to July 1986.

PRIOR CALIFORNIA LAW. Lump sum withdrawals were averaged over 7 years. There was capital gains treatment (exclusion of 50% of increase) on contributions made prior to 1974.

California conformed with prior federal law's "three-year rule" on the treatment of employee contributions.

New California Law conforms with the new federal treatment beginning in 1987.

CHILD CARE CREDITS

PRIOR FEDERAL LAW. Taxpayers who pay for employment-related child care expenses may take a credit for these expenses. For taxpayers with adjusted gross incomes of \$10,000 or less, the credit is equal to 30 percent of expenses. For taxpayers with adjusted gross incomes between \$10,000 and \$28,000, the credit is reduced by 1 percent for each additional \$2000 of adjusted gross income (e.g., there is a 28 percent credit for adjusted gross incomes between \$12,000 and \$14,000). For those with adjusted gross incomes of \$28,000 or more, the credit is 20 percent. The maximum amount of expenses against which a credit which may be taken is \$2400 for one child or \$4800 for two or more children.

NEW FEDERAL LAW. The Tax Reform Act of 1986 made no changes to the child care credit.

PRIOR CALIFORNIA LAW. The State credit was 10 percent of the allowable federal credit for those with adjusted gross incomes of \$20,000 or less and 5 percent of the federal credit for those with adjusted gross incomes of more than \$20,000.

New California Law conforms with the federal child care credit, at an amount equal to 30% of the credit allowed by the federal law, regardless of income. The credit sunsets in 1992.

RENTERS' CREDIT

PRIOR FEDERAL LAW. There is no comparable provision.

NEW FEDERAL LAW. There is no comparable provision.

PRIOR CALIFORNIA LAW. A refundable credit was available to renters. For single filers, the credit is \$60, for married filers and heads of household, the credit is \$137, and for joint custody heads of households, the credit is \$99.

New California Law retains the renter credit.

CHECK-OFFS

PRIOR FEDERAL LAW. A taxpayer may "designate" that \$1 of his or her tax be contributed to the Presidential Election Campaign Fund by checking a box on the tax return.

NEW FEDERAL LAW. The Tax Reform Act of 1986 made no changes to the check-off.

PRIOR CALIFORNIA LAW. Taxpayers may make nondeductible contributions for the following:

- California Election Campaign Fund (to a designated political party; taxpayer and spouse may contribute a maximum of \$25 each)
- California Fund for Senior Citizens (Senior Legislature)
- Rare and Endangered Species Preservation Program
- State Children's Trust Fund for the Prevention of Child Abuse
- United States Olympic Committee Fund

New California Law retains the five check-off contributions, but sunsets them at the end of 1991.

OTHER PROVISIONS AFFECTING INDIVIDUALS

TAX FORMS

The new law instructs the Franchise Tax Board to make use to the maximum extent possible of forms and procedures used by the federal government. This will enable taxpayers to use for state tax purposes most of the figures which they have already prepared for federal tax purposes, thus dramatically simplifying the state return preparation process.

JOINT CUSTODY HEAD OF HOUSEHOLD

The new law repeals the present joint custody head of household tax schedule, and allows instead a tax credit which approximates the same benefits as the prior special filing status. This change will allow simplification of the tax forms by making the federal and state filing status identical.

MISCELLANEOUS CHANGES

Retains the present state rule allowing flexibility in timing of tax on agricultural cooperative patronage dividends of farmers.

Repeals the current deduction for political contributions, and instead allows a 25% credit, not to exceed \$25 (\$50 for joint).

Repeals ridesharing provisions.

Sunsets all other credits (except the renter credit) in either 1991 or 1992.

Conforms with federal law by:

- eliminating the \$1,000 exclusion for life insurance amounts paid after the date of death which exceed the death benefit;
- limiting favorable treatment of structured settlement agreements to cases of physical injury, sickness or death;
- denying deduction for interest on certain policyholder loans where aggregate loan is \$50,000 or more;
- allowing prearranged funeral expense contract to be treated as a life insurance contract;
- requiring a taxpayer to file a timely insurance claim in order to deduct unreimbursed casualty loss;

- restricting the kinds of payments which are classified as alimony and thus are taxable to the recipient and deductible to the payor;
- adopting federal changes relating to Simplified Employee Pensions (SEPs) and self-employed (Keogh) plans;
- providing for exclusions or deductions of specified employee benefits, such as health insurance costs for self-employed persons, educational, group legal and dependent care assistance benefits, and post-retirement group-term life insurance (with applicable sunset dates);
- adopting federal exclusions for scholarships and fellowships, prizes and awards, and certain foster care payments;
- allowing step-up in basis of surviving spouse's half of community property;
- requiring unearned income of dependent children to be taxed at the parents' highest marginal tax rate;
- disallowing a taxpayer from claiming the personal exemption credit if he or she is claimed as a dependent on the parents' tax return.

PROVISIONS AFFECTING BUSINESS**CORPORATE TAX RATES**

PRIOR FEDERAL LAW. A corporation's income was taxed at rates from 15 percent on the first \$25,000 of taxable income to 46 percent of taxable income exceeding \$100,000. (See table below.)

NEW FEDERAL LAW. The top corporate rate is reduced to 34 percent. (See table below.)

<u>Taxable Income</u>	<u>Prior Law</u>	<u>Tax Rate</u> <u>New Law</u>
25,000 or less	15%	15%
25,001- 50,000	18	15
50,001- 75,000	30	25
75,001-100,000	40	34
Over 100,000	46	34

(Note: Under prior law, a 5 percent surcharge was imposed on taxable income between \$1 million and \$1.405 million. Corporations with taxable incomes in excess of \$1.405 million paid a flat 46 percent. Under new law, a 5 percent surcharge is imposed on taxable income between \$100,000 and \$335,000. Corporations with taxable incomes in excess of \$335,000 will pay a flat rate of 34 percent.)

PRIOR CALIFORNIA LAW. The tax rate on general corporations was 9.6 percent regardless of income. The tax on banks and financial institutions was set by the Franchise Tax Board based on a statutory formula and cannot exceed 12 percent.

New California Law decreases the corporate tax rate to 9.3%.

CAPITAL GAINS

PRIOR FEDERAL LAW. The tax on capital gains for corporations was 28 percent.

NEW FEDERAL LAW. Capital gains are taxed at the same rate as other taxable corporate income. There is a limit of \$3,000 on the carryover of capital losses.

PRIOR CALIFORNIA LAW. There was no special treatment for capital gains and losses for corporations. Gains were treated as ordinary income for tax purposes.

New California Law does not affect capital gains of corporations.

CORPORATE LIQUIDATIONS

PRIOR FEDERAL LAW. No gain to the corporation is realized when appreciated property is distributed to shareholders in a liquidation (under the Supreme Court's 1935 General Utilities decision).

NEW FEDERAL LAW. Gain is recognized to the corporation as well as to the shareholders in corporate liquidations.

PRIOR CALIFORNIA LAW. The State has generally conformed to prior federal law.

New California Law conforms with the new federal rules on corporate liquidations.

DEPRECIATION

PRIOR FEDERAL LAW. The cost of personal property was recovered over a 3, 5, 10, or 15-year period, depending upon the type of property. Each period has a specific percentage of recovery allowed -- e.g., recovery percentages for 3-year property are 25%, 38%, and 37%, while those for 5-year property are 15%, 22%, 21%, 21%, and 21%.

For real property, the depreciation period depends on the type of property and when it was placed in service. All low-income housing and other property placed in service before March 1984 is depreciated over 15 years. Property placed in service between March 1984 and May 1985 is depreciated over 18 years, while property placed in service after May 1985 is depreciated over 19 years. This system was known as the Accelerated Cost Recovery System (ACRS).

NEW FEDERAL LAW. The new law more closely resembles California's current law. Personal property is recovered over a 3-, 5-, 7-, 10-, 15-, or 20-year period, depending upon the type of property. Most personal property can be depreciated using a double declining balance method. The cost of real property is recovered using the straight-line method over 27.5 years for residential real property and over 31.5 years for nonresidential real property.

PRIOR CALIFORNIA LAW. State law used Asset Depreciation Ranges (ADR), which divided property into classes of useful lives based on the uses to which they are put. These classes were the same as those for new federal law (3 to 20 years for personal property, 27.5 and 31.5 years for real property). The owner selects a depreciation method to be used over the life of the property.

New California Law generally conforms with the new federal depreciation rules, effective for assets put into service in 1987 and thereafter, for individual taxpayers only. Corporations will continue to use the ADR system

DEDUCTIONS

MEALS, TRAVEL, AND ENTERTAINMENT EXPENSES

PRIOR FEDERAL LAW. Business expenses for entertainment and meals and lodging away from home were fully deductible.

NEW FEDERAL LAW. Most travel expenses remain fully deductible, but meals and entertainment expenses will be only 80 percent deductible.

PRIOR CALIFORNIA LAW. The State conformed with prior federal law.

New California Law conforms with new federal law.

SALES TAX

PRIOR FEDERAL LAW. Sales tax paid was deductible as a business expense.

NEW FEDERAL LAW. The full sales tax deduction is eliminated. Sales tax paid on acquisition of depreciable property used in business must be added to the basis of the property and capitalized.

PRIOR CALIFORNIA LAW. The State conformed to prior federal law.

New California Law conforms with the new federal treatment of sales tax.

NET OPERATING LOSSES

PRIOR FEDERAL LAW. A net operating loss occurs when allowable deductions exceed gross income. Taxpayers are allowed a deduction for net operating losses (NOLs) incurred in the conduct of business or trade. If the deduction exceeds the taxpayer's tax liability for the year in which the loss is incurred, the loss deduction generally may be carried back to the three preceding tax years and carried forward to the succeeding 15 tax years in order to offset taxable income. The taxpayer may receive a refund if the loss carryback results in an overpayment of taxes for a prior year.

NEW FEDERAL LAW. Limits are placed on the use of carryforward NOLs following a change of 50 percent or more of the corporate ownership.

PRIOR CALIFORNIA LAW. The State allowed net operating losses to be carry forward only for taxpayers engaged in a new small business, a business in an enterprise zone or economic development program area, or in farming. There were limits on the amount of losses which could be carried forward. There were no carryback provisions.

New California Law One half of net operating losses for 1987 through 1991 may be carried forward for 15 years and deducted against net income. Also, one half of 1985 and 1986 losses may be carried over to 1987, 1988 and 1989. The entire provision sunsets at the end of 1991.

SUBCHAPTER S CORPORATIONS

PRIOR FEDERAL LAW. Certain corporations are exempt from the corporation tax. Instead, shareholders of the business are taxed as if they were partners in a partnership. The business itself acts as a conduit through which income, losses, deductions and credits are passed on to the shareholders. These items are included in the computation of the tax liability of the individual shareholders on a pro rata basis, whether or not the shareholder has received a dividend from the corporation.

Businesses which are eligible for the Subchapter S treatment are domestic corporations with 35 or fewer shareholders.

NEW FEDERAL LAW. The Tax Reform Act of 1986 did not make any changes to these provisions.

PRIOR CALIFORNIA LAW. The State had no provisions for Subchapter S treatment for small business corporations.

New California Law conforms with federal Subchapter S provisions. The net corporate income is also subject to a 2.5% corporate tax.

PREFERENCE TAX / ALTERNATIVE MINIMUM TAX

PRIOR FEDERAL LAW. Corporations were subject to an add-on tax, equalling a percentage of certain preferences minus regular tax paid. (Tax preferences include excess accelerated depreciation on property, excluded dividends, excess percentage depletion allowances and intangible drilling costs, and excess long-term capital gains.) The add-on minimum tax rate of 15% was applied to the amount by which alternative minimum taxable income exceeded either \$10,000 or the taxpayer's regular tax liability.

NEW FEDERAL LAW. An alternative minimum tax (AMT), at a 20% rate, must be paid if it exceeds the amount of regular tax due. AMT is based on alternative minimum taxable income, which includes adjusted gross income and tax preferences, less a \$40,000 exemption.

PRIOR CALIFORNIA LAW. There was an add-on preference tax on certain "items of tax preference" in addition to the regular tax. The preference tax rate, after exemptions, was 2.5%.

NEW CALIFORNIA LAW conforms with the new federal alternative minimum tax, at a 7% rate.

OIL, GAS AND RESOURCES

PERCENTAGE DEPLETION

PRIOR FEDERAL LAW. 22 percent of gross income from natural gas sold subject to a fixed contract may deducted. The amount of this depletion allowance cannot exceed 50 percent of the property's taxable income. Independent producers of oil and gas are limited to a 15 percent depletion allowance. This depletion allowance cannot exceed 65 percent of taxable income from all sources.

NEW FEDERAL LAW. The only change in depletion allowance provisions is that payments for lease bonuses and advance royalties will not be eligible for percentage depletion.

PRIOR CALIFORNIA LAW. State law limited the amount of depletion deduction. If depletion exceeded \$1.5 million, the deduction was reduced by 125 percent of the amount over \$1.5 million.

New California Law retains the state cap on depletion deductions, but conforms with new federal provisions denying percentage depletion for lease bonuses and advance royalties.

INTANGIBLE DRILLING COSTS

PRIOR FEDERAL LAW. Expenses necessary for preparation and drilling of wells can be deducted. For large producers, which refine as well as drill for oil and gas, 20 percent of intangible drilling costs must be amortized over 3 years.

NEW FEDERAL LAW. Large producers must now amortize 30 percent of intangible drilling costs over 5 years. Foreign intangible drilling costs must be amortized over 10 years.

PRIOR CALIFORNIA LAW. The bank and corporation law did not require large producers to amortize any intangible drilling costs.

New California Law conforms with the new federal requirement that 30 percent of intangible drilling costs be capitalized and amortized over 60 months.

FINANCIAL INSTITUTIONS -- BAD DEBT RESERVES

PRIOR FEDERAL LAW. Commercial banks may compute their bad debt deduction either based on the actual amount of bad debts incurred during the year or a reserve method. The reserve method allows banks to take a deduction based on six-year estimates of uncollectable loans.

NEW FEDERAL LAW. Large banks (those with gross assets over \$500 million) not use the reserve method; they may take a deduction only on actual losses.

PRIOR CALIFORNIA LAW. Franchise Tax Board regulations allowed deductions for bad debts to be calculated based on: three- or six-year estimates of bad debts, additions which need to be made to the bad debt reserve to maintain its reserve as of 1976, or another method if facts and circumstances warranted.

The unitary reform bill enacted in 1986 (SB 85 - Alquist) conformed with the federal bad debt reserve changes for corporate nonfinancial taxpayers, beginning in 1988.

New California Law does not conform with the new federal prohibition on use of the reserve method for large banks, and retains the pre-existing difference by allowing banks and savings & loans a choice of three averaging methods.

HOUSING AND REAL ESTATE

LOW-INCOME HOUSING CREDIT

PRIOR FEDERAL LAW. There was no provision.

NEW FEDERAL LAW. A 9 percent credit annually for 10 years is available for construction or rehabilitation of low-income housing which is not federally subsidized. A 4 percent credit is available for the same period if there is a federal subsidy. To qualify, 20 percent of the units must be rented to those whose incomes are 50 percent or less of the area's median income. Alternatively, 40 percent of the units must be rented to those whose incomes are 60 percent or less of the area's median income. Rents cannot exceed 30 percent of the income eligibility levels.

Each state is allocated \$1.25 per capita in low-income housing credits annually. California's share is approximately \$35 million.

PRIOR CALIFORNIA LAW. There is no comparable provision in State law.

New California Law adds to the new low income housing credit by allowing a total state credit of 30% over 4 years on top of the federal credit. Low income housing must be maintained for 30 years, rather than the 15 years specified in federal law, with an "opt out" provision for special circumstances. The credit sunsets in 1990, but construction of housing started after 1987 qualifies for the full 30%

CONTRIBUTIONS IN AID OF CONSTRUCTION

PRIOR FEDERAL LAW. Contributions which were made to public utilities for construction purposes were considered contributions to capital and thus excluded from gross income. Developers would make such contributions as part of their building projects.

NEW FEDERAL LAW. Contributions to a public utility to encourage the provision of services are now considered income, and are subject to tax.

PRIOR CALIFORNIA LAW. The State conformed with prior federal law.

New California Law does not conform with new federal taxation of contributions in aid of construction.

SPECIAL CREDITS

RESEARCH AND DEVELOPMENT

PRIOR FEDERAL LAW. A 25 percent credit was available for the amount research expenditures exceed the average amount of expenditures during the prior three years. This credit expired December 31, 1985.

NEW FEDERAL LAW. The research credit is extended through 1988, but is reduced to 20 percent. For tax years beginning after 1986, a 20 percent tax credit is available to corporations for expenditures on basic research conducted by universities. The credit applies against expenditures which exceed a specified base amount.

PRIOR CALIFORNIA LAW. There was no provision for a research credit.

New California Law conforms with the federal credit for incremental research and development, at an 8 percent rate (12 percent for basic and applied research conducted by universities and certain non-profit institutions) for both personal income tax and corporation tax. This credit sunsets at the end of 1992.

INVESTMENT TAX CREDIT

PRIOR FEDERAL LAW. A 10 percent credit was allowed on equipment purchases.

NEW FEDERAL LAW. The credit is repealed for property placed in service after 1985.

PRIOR CALIFORNIA LAW. There was no provision for an investment tax credit.

New California Law -- No investment tax credit

ORPHAN DRUG CREDIT

PRIOR FEDERAL LAW. A credit of 50 percent is allowed for costs associated with development of orphan drugs.

NEW FEDERAL LAW. The orphan drug credit is unaffected by the new federal law.

PRIOR CALIFORNIA LAW. There was no provision for an orphan drug credit.

New California Law provides for an orphan drug credit at a 15 percent rate, for drug testing in California.

ACCOUNTING PROVISIONS

CASH METHOD OF ACCOUNTING

PRIOR FEDERAL LAW. Businesses without inventories could use the cash method of reporting income even though the accrual method was used for financial reporting.

NEW FEDERAL LAW. Corporations (other than S corporations and personal service corporations), partnerships which have a corporation as a partner, and tax shelters must use the accrual method. Farming businesses may continue to use the cash method.

PRIOR CALIFORNIA LAW. The State conformed with prior federal law.

New California Law conforms with the new federal cash method rules.

INSTALLMENT SALES

PRIOR FEDERAL LAW. Gain from the sale of property generally is recognized (and the tax is due) in the year in which the property is sold. However, gain from installment sales, where the seller receives deferred payments, is reported incrementally over two or more years based on the ratio of the installment payments to the gross profits.

NEW FEDERAL LAW. The installment method of accounting cannot be used for any sale of personal property under a revolving credit plan nor for the sale of stock or securities sold on an established market.

The use of the installment accounting method in the sale of real property is limited, based on the seller's indebtedness, through the "proportionate disallowance" rule. The limitation on the use of the installment method applies to (1) real property held for sale to customers in the ordinary course of the seller's trade or business or (2) real property used in the seller's trade or business or held for the production of income but only if the sale price of the property exceeds \$150,000.

PRIOR CALIFORNIA LAW. The unitary reform bill of 1986 (SB 85 - Alquist) conformed state corporate taxation with the new federal installment sales provisions, starting with the 1988 income year.

New California Law allows noncorporate taxpayers the option of not being subject to the "proportionate disallowance" rule.

LONG-TERM CONTRACTS

PRIOR FEDERAL LAW. A long-term contract (for building, installation, or manufacturing) is one which is not completed within the tax year. A taxpayer can choose to report long-term contract income under one of two methods. Under the percentage-of-completion method, income from the contract is reported based on the portion of the contract completed during the year and expenses are deducted when incurred. Under the completed contract method, income and expense from the contract are reported in the tax year in which the contract is completed.

NEW FEDERAL LAW. 40 percent of the contract must be reported under the percentage-of-completion method, while the balance can be reported using the taxpayer's regular method.

PRIOR CALIFORNIA LAW. The State generally conformed with prior federal law. However, corporations doing business

in more than one state could be required to use the percentage of completion method rather than the completed contract method in order to prevent tax avoidance.

New California Law conforms with the new federal long-term contract rules.

CAPITALIZATION RULES

PRIOR FEDERAL LAW. Manufacturers were required to accumulate the costs of producing inventory goods in an inventory account; these costs could then be deducted when the goods to which they correspond were sold. The Treasury Department had issued regulations which specified how direct and indirect production costs were to be accounted based on the nature of the cost.

For purchasers of goods for resale -- wholesalers and retailers -- the inventory account included the invoice price of the purchased goods plus transportation and other costs of acquiring the goods.

NEW FEDERAL LAW. The Act specifies uniform capitalization rules which set forth how costs must be capitalized by those who produce goods or acquire them for resale. Several items now being expensed (deducted) must now be capitalized -- e.g., storage costs, repackaging costs, wages of employees who purchase inventory.

PRIOR CALIFORNIA LAW. The State conformed with prior federal law.

New California Law conforms with the new federal capitalization rules.

OTHER PROVISIONS AFFECTING BUSINESS

The new California law:

- Allows the special deferral of capital gains for mobilehome parks which are sold to park residents to sunset as scheduled in 1988;
- Conforms to changes made in 1984 and 1985 federal acts dealing with original issue discount, deferred payment loans and below-market interest transactions;
- Conforms with the federal rules:
 - limiting or denying deductions for cruises or conventions under specified circumstances;
 - limiting home office expense deductions to cases where a taxpayer leases part a home to the employer;

- allowing nonrecognition of gain on sale of certain low-income housing projects if gains are reinvested in another such project;
- relating to straddle options and incentive stock options;
- relating to reporting of farm-related income and deductions;
- allowing percentage depletion for hard minerals, and other provisions relating to mining and exploration.

Prepared by staff of Senate and Assembly Revenue and Taxation
Committees

January, 1988

APPENDIX

FISCAL EFFECT - INDIVIDUAL TAX PROVISIONS

	1987	1990
	(\$ Millions)	
<u>TAX BASE ITEMS</u>		
Full Taxation of Capital Gains	\$ 764	
Conformity to Other Tax Base Items	<u>1175</u>	
SUBTOTAL		1939
<u>TAX RATES, BRACKETS, AND STANDARD DEDUCTION</u>		
Reduce Top Rate to 9.3% and Reduce Eleven Rates to Six: 1%, 2%, 4%, 6%, 8%, and 9.3%	-1512	
Conform to Federal 1987 Standard Deduction of \$3,760 for Joint Returns (Single = Half of Joint), Indexed Thereafter	<u>- 50</u>	
SUBTOTAL		-1562
<u>PERSONAL EXEMPTION AND SENIOR CREDITS</u>		
Increased Personal Exemption Credit From \$45 to \$51, Increase Dependent Credit From \$14 to \$51, Repeal \$1,000 Senior Income Exclusion and Allow \$51 Senior Credit, and Deny Personal Exemption Credit to Persons Claimed as Dependent on Another Return	<u>- 304</u>	
<u>OTHER CREDITS</u>		
Increase Child Care Credit to 30% of Federal	- 41	
Low Income Housing Credit	- 16	
R&D Credit	0	
Solar Tax Credit	- 5	
Political Contributions Credit	- 7	
Tax Credit Against Capital Gain on Rental Residential and Farm Property	<u>- 25</u>	
SUBTOTAL	- 94	
SUBTOTAL -- ALL TAX PROVISIONS	- 21	\$ - 39 *
<u>COMPLIANCE PROVISIONS</u>	18	18
GRAND TOTAL -- PERSONAL INCOME TAX	<u>\$ - 3</u>	<u>\$ - 21</u>

(* 1990 itemized subtotals not available)

CHANGE IN TAX LIABILITY, BY FAMILY INCOME

Family Income (\$ Thousands)	-----1987-----		-----1990-----	
	Change in Tax Liability (\$ Millions)	Change as % of Current Law	Change in Tax Liability (\$ Millions)	Change as % of Current Law
under \$10 w/pref. income*	\$ 14.5	45%	\$ 6.0	8%
under \$10 w/o pref. income	- 6.0	n/a	- 17.2	n/a
\$10 - 15	- 4.6	- 60	- 4.3	- 45
15 - 20	- 13.0	- 37	- 12.3	- 33
20 - 30	- 49.5	- 15	- 64.8	- 22
30 - 50	- 177.5	- 9	- 214.2	- 10
50 - 100	- 2.4	0	- 67.8	- 1
100 - 200	41.3	2	103.3	2
over 200	203.5	7	265.5	5
Total**	\$ 6.3	0%	\$ - 5.8	0%

Number of Families With Tax Decreases in 1987: 6.05 million (71%)

Number of Families With Tax Increases in 1987: 2.44 million (29%)

Number of Currently-Taxable Families Made Nontaxable in 1987: 278,000

* Families with income of "under \$10,000 with preference income" are those who have income from sources receiving preferential treatment. They are likely to have high levels of total income that have been reduced to below \$10,000 by depreciation, losses, or other provisions which shelter income.

** This table does not reflect the effect of a small number of provisions which could not be included in the estimates.

FISCAL EFFECT - CORPORATION TAX PROVISIONS

	1987	1988 (\$ Millions)	1989	1990
<u>BASE BROADENING ITEMS</u>				
Selected conformity items -- TRA 86	\$ 622	\$ 526	\$ 539	\$ 455
Pre-existing nonconformity: OID and hard mineral depletion	- 2	1	4	9
SUBTOTAL	<u>619</u>	<u>527</u>	<u>544</u>	<u>463</u>
<u>SUBCHAPTER S</u>				
Full conformity with a 2.5% surtax	-249	-298	-346	-391
<u>NEW OPERATING LOSSES - 50% LOSS LIMIT - Sunsets 1/1/92</u>				
1985 and 1986 Losses (3 years)	-269	-180	-140	0
1987 to 1991 Losses (15 years)	0	-187	-313	-428
NOL/Sub S Interaction	0	22	37	52
TOTAL NOL	<u>-269</u>	<u>-345</u>	<u>-416</u>	<u>-376</u>
<u>ALTERNATIVE MINIMUM TAX</u>				
Repeal add-on preference tax & conform to federal AMT at 7% rate in 1988 and future years	0	223	193	183
<u>MINIMUM TAX</u>				
Increase minimum tax to \$300 in 1987, \$600 in 1989, and \$800 in 1990	28	29	136	219
Extend minimum tax to limited partnerships beginning in 1988	0	23	48	68
<u>TAX CREDITS</u>				
Research and development (8%/12%)	0	- 25	- 16	- 12
Low income housing	- 2	- 4	- 6	- 6
Commercial solar	- 4	- 3	- 1	- 1
Orphan drugs	- 1	- 1	- 1	- 1
<u>TAX RATE REDUCTIONS</u>				
Reduce rate to 9.3%	-161	-169	-182	-195
SUBTOTAL -- ALL TAX PROVISIONS	<u>- 38</u>	<u>- 42</u>	<u>- 48</u>	<u>- 49</u>
<u>COMPLIANCE PROVISIONS</u>	16	16	17	17
GRAND TOTAL -- CORPORATE PROVISIONS	<u>\$ - 22</u>	<u>\$ - 26</u>	<u>\$ - 31</u>	<u>\$ - 32</u>