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Explanation of

TAX REFORM PROGRAM
(AB 1000 & AB 1001)

Assembly Committee on Revenue & Taxation
April 1970

INDEX (AB 1000 and AB 1001) ... by subject matter

HOMEOWNERS' EXEMPTION (AB 1001, Sec. 30)

A. Proposal:

(1) Increase the homeowners' exemption for owner-occupied, single-family homes on two acres or less to $1,000 assessed value plus 20% of the remaining assessed value.

(2) Increase the homeowners' exemption for owner-occupied, single-family homes on two acres or more, condominiums, and duplexes to $1,500 of assessed value.

(3) Provide for the first time a $1,500 homeowners' exemption to:
   (a) owner-occupied, multiple dwelling units
   (b) cooperatives owned by corporations in which tenants own a share,which gives them exclusive use of a dwelling unit (Roosmoor-type cooperatives).

B. Fiscal Implications:

General fund cost

1970-71	$388 million
1971-72	422 "

C. Present Law:

Under present law, a $750 exemption of assessed value is available for all owner-occupied, single-family homes condominiums, and duplexes.

D. Rationale:

(1) Increasing the homeowners' exemption reduces the regressivity of the property tax.

(2) Since the homeowners' exemption decreases taxes on 35% rather than on 100% of taxable property, greater tax reductions, for homeowners,can be achieved through this exemption than through general property tax reduction programs.

(3) The exemption of 20% of the assessed value, after $1,000 exemption, mitigates the assessors' ability to reduce the significance of the homeowners' exemption.

(4) Increasing the homeowners' exemption is a form of property tax reduction visable to taxpayers.

RENTER RELIEF PROGRAM (AB 1000, Sec. 48)

A. Proposal: This program would allow a qualified renter a tax credit against his personal income tax liability in the amount of $50 or the tax liability, whichever is smaller. The credit is $50 in the case of a single individual, head of household, or married couple filing jointly. Married couples filing separately may divide the credit or the credit may be claimed by one spouse.

A qualified renter is an individual who was a resident of this State and rented premises as his principal place of residence as of March 1 of the taxable year, unless such premises were exempt from property taxes.

B. Present law:

Contains no provisions for property tax relief for renters.

C. Fiscal Implications:

Costs are estimated by the Franchise Tax Board to be $85 million in the first year.

Coverage is estimated at about 2 million households.

D. Rationale: Although only few studies have been made on the subject, most authorities would agree that renters do indeed pay some portion of the owner's property tax liability in their rental payments.

Since persons who rent property can be expected to cover all costs of doing business as other entrepreneurs do, this would be the logical assumption.

Most studies have shown that property taxes constitute generally 13% to 25% of the renter's annual payments. However, the studies are not consistent in their results, and the evidence is even more contradictory in terms of the amount of property tax <u>increases</u> that are reflected in increased rental charges.

In its provision of a flat dollar amount of relief rather than a given percent of rental payments, this proposal recognizes that renters do pay property taxes but that the average percent is uncertain and unknown.

The $50 tax credit is roughly equivalent to the amount of property tax relief received by homeowners.

BUSINESS INVENTORIES (AB 1001, Sec. 13, 31)

A. Proposal: Beginning on the 1971 lien date, increase the exemption for business inventories from property tax to 50%.

Inventories are defined by present law to include:

1. Goods intended for sale or resale in the ordinary course in business.

2. Raw material and work in process with respect to such goods.

3. Animal and crops held for sale or resale.

4. Animals used for the production of food or fiber and feed for such animals.

B. Fiscal Implications:

First full years costs should fall between $130-140 million, depending on certain unknowns of economic growth.

C. Present Law:

Present law provides for an exemption of 30% of inventories for 1970 and 1971 and a 15% exemption for each year thereafter.

D. Rationale:

1. Business inventory taxation has long been viewed as undesirable. Studies by the Assembly Committee on Revenue and Taxation, National Tax Association and recently by the Advisory Commission on Intergovernmental Relations have all condemned this tax.

2. Inventory taxes place California at a definite disadvantage in competing with other states for new industries and jobs. California needs both. Arizona, Nevada, Oregon, and Hawaii all give tax advantages to inventories. California is isolated by her neighbors.

3. Inventory taxes cause an annual slow-down in business activity prior to March 1 that causes a loss in warehouse occupancy in California, fewer goods available to consumers, loss in business income and jobs, and loss in tax revenue to state and local government.

4. Inventory taxes are inequitable. They produce serious tax inequities between businesses requiring inventories and those that do not, and even a disparity of tax burdens between businesses requiring inventories due to differences in turnover, seasonal fluctuations, etc.

5. Inventory taxes hinder the efficient operation of free markets and reduce income from other tax sources.

6. Inventory taxes are regressive. They are passed on to the consumer and are imposed on such items as food, medicine, clothing, etc.

WELFARE - MEDI-CAL TAX RELIEF (AB 1001, Sec. 100, 101, 104-7)

A. Proposal:

1. Welfare:
   a) Provides for uniform 75% state/25% local sharing ratio for categorical aids program.

   b) Requires counties to pay their full 25% share up to a tax rate of 25¢ per $100 percent of assessed value.

   c) Reduces counties share of remaining costs to 7½% of the state-local costs of categorical aids.

2. Medi-Cal:
   a) Counties would no longer be required to participate financially in the Medi-Cal (Title XIX) program.

   b) The State of California would no longer constitute to any county medical indigent program through the "county option".

B. Fiscal Implications:

The Legislative Analyst's office estimates costs in millions at:

1970-1	71-2	72-3	73-4
$143	$167	$194	$225

C. Present Law:

The five categorical aid welfare programs now have five different sharing ratios. The counties fully fund their share from locally levied revenues.

D. Rationale:

1. Provides tax relief to all property taxpayers in all counties.

2. Equalizes the welfare burden among the counties and removes the heavy load from counties with high welfare costs.

3. Restores full local control to counties in the design and management of their medically indigent program.

4. Provides administrative simplification and substantial cost savings in Health Care Services.

OPEN SPACE PROGRAM

A. Proposal: 1. Mandates all counties to make available the provisions of the Land Conservation Act to all eligible properties.

2. Provides for payments to local government for land under open-space restrictions as follows:

	Prime	Non-Prime
Counties	$1.50	$ .50
Schools:		
Elem. district	.75	.25
High school district	.60	.20
Junior college district	.15	.05
Unified	1.35	.45
Cities	1.50	.50

B. Fiscal Implications:

Depending on how much additional land will be placed under agreement as a result of the provisions of this measure, it is estimated that the cost to the state will be $8 million in 1970-71 and $13 million in 1971-72.

C. Present Law:

The Land Conservation Act is optional with counties and there are no state funds provided to local government for open-space lands under restriction.

D. Rationale:

The need to save prime agricultural lands and other open-space lands is one of statewide concern. The program cannot be effective if a number of important counties refuse to implement the program.

This proposal would help preserve the rapidly-disappearing open spaces in California.

A flat rate payment was selected for payment to counties to help cushion the revenue impact in local areas. It is impossible to administer a program and protect the state's treasury if the state were to attempt actual reimbursements -- as the assessor only makes one assessment -- that based on open-space use.

SALES TAX (AB 1000, Sec. 40-42)

A. Proposal:

1. Rate increase: increase the State sales and use tax rate from 4% to 5%, making the total 6% on all sales taxable transactions.

2. Administrative charge to local governments: at the present time, the local governments pay 1/5 of the State Board of Equalization's administrative costs because they get 1/5 of the revenue distributed to local governments, and, therefore, this measure provides that beginning July 1, 1970, they will pay costs on the basis of 1.02% of the revenue they receive.

3. Contractor's exemption: exempts from the increase in sales and use tax the taxable purchases made by contractors if the items are used in performing work contracted for because the increase in tax was enacted.

B. Present Law:

1. Rate: the present rate of the sales and use tax is 5%, constituting 4% for the state and 1% for cities and counties.

2. Administrative charge: local governments presently pay for 1/5 of the State Board of Equalization's administrative costs attendant to collecting and distributing the sales and use tax.

3. Contractor's exemption: there is no effective provision in present law that exempts purchases made by contractors. However, a similar special provision was enacted in 1967 when the sales tax was increased 1¢.

C. Fiscal Implications:

Estimated revenue increase in millions:

	70-1	71-2	72-3
Rate Increase	$422	$492	$525
Contractor's exemption	-12	- 2	- 0
Net Increase	$410	$490	$525

D. Rationale:

1. Rate increase: although many object to the rise of the sales tax on the grounds that it is a regressive tax, the sales tax in California

exempts food, housing and prescription drugs from taxation and by doing so, becomes a nearly proportional tax. Recent studies indicate that the California sales tax has an index falling somewhere between .81 and .98 (1.00 indicates a proportional tax and less than 1.00 a regressive tax.)

In terms of this tax package, the sales tax increase partially offsets the business property tax relief as businesses pay a significant portion of the sales tax.

The sales tax is the most productive tax source at any given tax rate.

2. Administrative charge: the effect of the change in method of determining the costs to be paid by local governments will continue to pay what they now do.

3. Contractor's exemption: an exemption for contractor's purchases necessary to complete existing contractual arrangements is generally provided when sales and use tax increases are proposed.

BANK & CORPORATION TAX RATE INCREASE OF ½% (AB 1001, Sec. 37-42, 72)

A. Proposal: Effective 1/1/72, this measure would increase the State's bank and corporation franchise rate to 7½%.

B. Present Law:
Present bank and corporation franchise tax rate is 7%.

C. Fiscal Implications:
When fully effective, this measure would provide approximately $50 million per year in revenue.

D. Rationale:

1. The business community will receive general property tax relief in the welfare provisions of this package as well as more specific relief in the form of business inventory tax relief. The timing of this increase corresponds to the increase in the cost of the inventory tax exemption for 1972-3.

2. The impact of the state corporate tax is greatly reduced because it's deductible from the federal income tax. Studies indicate the effective rate is less than half of the nominal rate.

LIMIT ON OIL DEPLETION ALLOWANCE (AB 1000, Sec. 86; AB 1001, Sec. 95)

A. Proposal: Limit depletion allowance for oil and gas wells to five times the adjusted cost of the taxpayer's interest in such property. The taxpayer would continue to deduct 27½% of gross income, up to 50% of net income until the point that the depletion allowances taken amounted to five times cost.

B. Fiscal implications:

The Franchise Tax Board estimates that for income year 1970, this proposal will produce $14.8 million in additional revenue.

C. Present law:

Under present law, California allows, for oil and gas, a depletion allowance which allows a deduction from taxable income of 27½% of gross income, not to exceed 50% of net income. There is no limit as to the extent that the depletion allowance may exceed the adjusted cost of property.

For federal income taxes, the depletion allowance was reduced by the Tax Reform Act of 1969 from 27½% to 22%. The Franchise Tax Board estimates that conformity, just on the oil and gas depletion figure of the new federal law, would produce $4.1 million in additional revenue.

D. Rationale:

1. There should be some limit on how much depletion is allows on any given property.

2. The Franchise Tax Board's most recent study of the depletion allowance for income years 1967 and 1968 reveals that on the average percentage, depletion results in a deduction equal to 15.6 times cost.

3. Certain natural resources producers, such as oil and gas, enjoy a tax deduction not enjoyed by other businesses. Many other businesses have assets which are losing value (depleted) due to obsolescence on other reasons and operate in a high risk field of endeavor. The motion picture industry would be a good example.

CAPITAL GAINS (AB 1000, Sec. 110,111,113)

A. Proposal: The provisions relating to capital gains contains the following changes:

(1)

Holding Period	Amount Taxes
0-1 years	100%
1-2 "	80%
2-5 "	65%
5-10 "	50%
over 10 "	40%

(2) Capital losses: the existing $1,000 capital loss limitation is changed to conform to the new federal treatment in regard to married persons filing separate returns. Under the new provisions, each spouse is allowed a deduction of $500 for a capital loss if separate returns are filed.

(3) Cattle and horses: under these provisions, the classification of cattle and horses as property used in a trade or business is conformed to the new federal law. Gain from the sale of cattle and horses held by the taxpayers for draft, breeding, dairy, or sporting purposes are accorded capital gain treatment only if held for 24 months or more.

(4) Miscellaneous: the bill contains several other provisions that appear to change the present treatment but actually preserve current treatment under the new provisions. For example:

(a) non-business bad debts are treated as a loss arising from a capital asset held for less than a year in order to preserve its current 100% deductibility status.

(b) a holding period of 5-10 years (50%) is attributed to a lump-sum distribution from a pension plan or employee annuity trust plan in order to preserve current treatment of 50% taxable.

(c) the holding periods attributed to capital loss carryovers are changed to preserve the same percentage treatment as they receive under current law.

B. Present Law:

(1) Holding period: under existing law, gain on assets held 6 months or less is treated as ordinary income and taxed at 100%; for assets held longer than 6 months only 50% of the gain is taxed.

(2) Capital losses: under present law, if married persons file separate returns, each spouse is allowed to deduct $1,000 for a capital loss.

(3) Cattle and horses: present law requires that cattle and horses as well as other livestock be held 12 months or more before eligible for capital gains treatment.

C. Fiscal Implications:

Revenue gains are estimated in millions for these income years by the FTB as follows:

	1970	1971	1972	1973
Change in Holding Period	18.6	21.6	23.3	26.8
Change in $500 Loss Limit	.7	.8	.8	.9

D. Rationale:

(1) Change in holding period: economists and most tax experts argue that the preferential treatment of capital gains income discriminating against some enterprises as well as individuals that do not have capital gains income and are not able to take their income in this form.

In addition, taxpayers' attempts to convert ordinary income into capital gains and the government's efforts to prevent this are often said to be responsible for many complexities in current provisions.

Many economists also argue that it is impossible to draw a clear distinction between capital gains and other income from property that doesn't qualify. On the other hand, compelling arguments have been made for a different treatment of capital gains because they often accrue over many years, are subject to the effects of inflation, and are realized at irregular intervals.

There is general agreement, however, that present provision go far beyond those required to avoid discrimination against capital gains and adverse effects upon investment.

In addition, present capital gains treatment violates the principle of tax neutrality by giving a tax premium to companies which conduct their financial affairs in a certain way.

(2) Capital losses: the new treatment of capital loss limitation for married taxpayers is aimed at preventing married couples from filing separately merely to take advantage of the $1,000 capital loss deduction for each spouse.

(3) Cattle and horses: in the case of these animals, it is generally felt that the taxpayer cannot determine within the existing 12-month period which animals he will keep for the specified purposes of draft, breeding, dairy, or sport.

WITHHOLDING (AB 1000, See Index)

A. Proposal: This measure provides:

1. Begin withholding of state personal income taxes beginning January 1, 1971, and require quarterly estimates if a person has $1,000 or more in income subject to tax from other than wages and salaries.

2. Repeal of the present October prepayment of one-half of the previous year's income tax paid.

3. Provides a tax credit of 40% for 1970 income taxes -- which represents 100% forgiveness of non-reoccuring revenues.

4. Establishes a 5% penalty for failure to pay income taxes on time plus a penalty of ½% per month for each month the tax remains unpaid (up to 36 months).

Withholding is a procedure for collecting State income tax when income is earned, by withholding the tax from wages and by quarterly estimates, similar to federal law.

Beginning on January 1, 1971, most wage earners will be subject to withholding in their regular payroll period.

If the amount withheld by an employer is more than $50 per month, the employer will remit to the State, on a monthly basis; if less than $50, the remittance will be required on a quarterly basis.

For persons with $1,000 in income, subject to tax, from other than wages and salaries, a quarterly estimate payment will be required beginning on April 15, 1970.

The second payment is due June 15 and the others on September 15 and January 15 of the following year.

No estimate need be made if the tax for the prior year is $100 or less, for joint returns.

B. Present Law:

In California, withholding of income taxes is only done for out-of-state residents.

C. Fiscal Implications:

Estimated Fiscal Impact (In Millions)			
1970-71	1971-72	1972-73	1973-74
$105	$220	$175	$180

D. Rationale:

1. Withholding produces substantial amounts of revenue every year which can be used to provide additional property tax relief.

2. Withholding is an effective mechanism for collecting from substantial numbers of persons who are evading State income taxes.

3. Withholding is the only means of correcting a very serious cash flow situation which now faces the State of California and which will get worse each year as the percent of general fund revenue from the personal income tax increases (the income tax is more elastic and grows faster than the other general fund revenue sources).

4. The Legislative Analyst's Analysis of the Budget Bill demonstrates the condition of the General Fund Cash Flow (page 919) in millions:

Month	Receipts	Disbursements	Current Deficiency or Excess
1970-71			
July	329	398	- 69
August	343	470	-127
September	234	377	-143
October	372	383	- 11
November	595	400	195
December	234	385	-151
1971-72			
January	265	391	-126
February	389	450	- 61
March	410	594	-184
	3,171	3,848	-677

5. Virtually all states but California and North Dakota that have a personal income tax also have withholding:

WITHHOLDING IN THE UNITED STATES

State	Year of Adoption	Degree of Forgiveness
Oregon	1948	None
Alaska	1949	N.A.
Delaware	1949	None

Vermont	1951	None
Arizona	1954	None
Colorado	1954	None
Kentucky	1954	None
Idaho	1955	None
Maryland	1955	None
Montana	1955	None
Alabama	1956	None
District of Columbia	1956	50%
Indiana	1956	None
Hawaii	1957	N.A.
Massachusetts	1959	None
New York	1959	Most*
Utah	1959	None
North Carolina	1960	None
South Carolina	1960	None
Georgia	1960	None
Louisiana	1961	None
West Virginia	1961	N.A.
Missouri	1961	None
Oklahoma	1961	None
New Mexico	1961	None
Minnesota	1961	75%
Wisconsin	1962	65%
Virginia	1963	None
Arkansas	1966	None
Iowa	1966	None
Kansas	1966	None
Nebraska	1967	N.A.
Michigan	1967	N.A.
Mississippi	1968	None
Maine	1969	N.A.
Illinois	1969	N.A.

Note: The states where forgiveness was not applicable is where withholding was introduced simultaneously with introduction of income tax.

*In New York, 1968's tax liabilities, except those on trusts, estates and capital gains, were forgiven. At the same time, however, the New York income tax was substantially increased to provide the revenue required by forgiveness.

PERSONAL INCOME TAX - Add 11% and 12% Rates (AB 1000, Sec. 46)

A. Proposal: This measure adds an 11% bracket to the personal income tax for taxable incomes over $32,000, beginning January 1, 1972, and a 12% bracket for incomes over $36,000 beginning January 1, 1973.

B. Present Law:
Presently, 10% is the highest income tax rates on personal taxable income, applying to taxable incomes over $28,000.

C. Fiscal Implications:
Revenue increases are estimated as follows: (in millions)

1971-2	1972-3	1973-4
$15	$60	$96

C. Rationale:

1. Increasing the tax rates for higher income taxpayers compensates for the higher property tax relief that they receive in the form of the 20% feature. This flat percentage reduction of assessed value will give more relief to taxpayers with higher valued homes.

2. The recent publication by the Advisory Commission on Intergovernmental Relations entitled "State and Local Finances", 1967 to 1970, demonstrates that in 1968, 20 areas had higher effective rates of personal incomes taxes for a married couple with two dependents and adjusted gross income of $25,000 (Table 39). These were: Alaska, Colorado, Delaware, District of Columbia, Georgia, Hawaii , Idaho, Kentucky, Maryland, Minnesota, Montana, New York, North Carolina, North Dakota, Oregon, South Carolina, Utah, Vermont, Virginia, Wisconsin. In many of these states, the burden was substantially higher than Californias, up to 90% higher in one state (Wisconsin).

I. MINIMUM INCOME TAX (AB 1000, Sec. 50; AB 1001, Sec. 41, 43)

A. Proposal: Impose a 1.5% tax on certain income exempt from income taxes. The tax is computed on the gross amount of exempt income, less

(1) $30,000
(2) Income taxes paid for the taxable year
(3) Net losses

Exempt income subject to the minimum tax includes:

(1) Excess of net investment interest over investment income
(2) Excludable capital gains
(3) Stock options: difference between option price and fair market value
(4) Accelerated depreciation on real property
(5) Accelerated depreciation of personal property subject to net lease
(6) Depletion: amount of allowable depletion less adjusted basis
(7) Bad debt deductions of financial institutions: amount of deduction allowed less amount which would be required, based on institutions actual loss experience

B. Fiscal Implication:

For 1970-71, the proposed tax would produce approximately $10.12 million based on federal fiscal effect.

C. Present Law:

The types of income subject to the proposed minimum income tax are now exempt from personal or corporate income taxation.

D. Rationale:

The present tax treatment which permits individuals and corporations to escape tax on certain portions of their economic income results in an unfair distribution of the tax burden. In recent years, there has been a significant number of cases where taxpayers with economic incomes of $1 million or more paid little or no income tax. United States Treasury studies also show people who paid little or no tax in one year are very likely to pay little or no tax in succeeding years.

Existence of this basic unfairness in the tax system undermines public confidence in the income tax and in government itself.

II. REAL ESTATE DEPRECIATION (AB 1000, Sec. 60, 61, 122-124; AB 1001, Sec. 82-84)

A. Proposal: Enact new depreciation rules as follows:

(1) 200% declining-balance method of depreciation allowed for rental residential property only

(2) 150% declining-balance method allowed for new real estate bought or constructed after July 24, 1969 only

(3) 125% declining-balance method allowed for used residential rental property only with a useful life of 20 years or more

(4) For all other property, only straight line depreciation will be allowed

(5) A five-year rapid write-off for capital expenditures made between July 24, 1969 and before 1975 for rehabilitation of substandard and slum housing rented to persons of low and moderate income. Such expenditure must not exceed $15,000 per unit

(6) The excess of post 1969 realty depreciation over straight line depreciation will be 100% recapture

B. Fiscal Implication:

The estimated state revenue gain from conformity to the new depreciation guidelines is:

1970 - Minor
1971 - $ 1.0 million
1972 - $ 1.8 million
1973 - $ 5.4 million
1974 - $ 7.9 million
1979 - $18.6 million

C. Present Law:

In general, taxpayers are now allowed the 200% declining-balance method for all new realty and the 150% declining-balance method for all used realty

D. Rationale:

Accelerated depreciation will frequently allow deductions in excess of the amount required to service the mortgage during the early life of the property, thus producing in many cases, a tax loss deductible against other income even though there is a positive cash flow.

In addition, accelerated depreciation usually produces a deduction far in excess of the actual decline of the usefulness of the property.

As a result of the fast depreciation and the ability to deduct amounts in excess of the taxpayer's equity, economically profitable real estate operations normally produce substantial tax losses, sheltering from the income tax the economic profit of the operation and permitting avoidance of income tax on the owner's other ordinary income -- such as salary and dividends. Later, the property can be sold and the excess of the sale price over the remaining basis is treated as a capital gain.

III. INCOME AVERAGING (AB 1000, Sec. 125-9)

A. Proposal: Extend income averaging to types of income now excluded from averaging -- capital gains, gambling income and gifts.

B. Fiscal Implication:

State revenue loss:
1970-71, $3 million
1971-72, $4 "

C. Present Law:

Taxpayers may now average income if current years income is 133-1/3% above his averageable income for the past four years. Excluded from the averaging provisions are capital gains, gambling,winnings, and gifts. Current year's income must be at least $3,000 in excess of average income.

D. Rationale:

Allowing additional types of income to be averaged will materially simplify the averaging computation. The present complexity of the procedure deters some eligible taxpayers from making use of income averaging.

In addition, there does not appear to be a valid reason for denying the averaging feature to types of income formerly excluded.

IV. MOVING EXPENSES (AB 1000, Sec. 54, 63)

A. Proposal: To expand the present moving expense deduction to include:

(1) Expenses for house hunting trips
(2) Temporary living expenses at new job location while waiting to move into permanent quarters (limit of 30 consecutive days)
(3) "Qualified" expenses incident to a sale, purchase or lease of a residence. The above deductions are limited to $2,500.

Self-employed are allowed to claim moving expense deduction.

The entire deduction is restricted to moves where the new principal place of work is 50 miles further distant from his old home than his old place of work.

Income received for moving expenses must be included in gross income.

B. Fiscal Implication:

State revenue loss of $ .7 million for 1970-71

C. Present Law:

Current California law allows a deduction for:
(1) The cost of transporting the taxpayer and his family from the old house to the new one
(2) The cost of transporting belongings, and
(3) The cost of meals and lodging in route.

To obtain this deduction, the taxpayer's new place of work must be 20 miles further from his old home than his old place of work. In addition, the taxpayer must be employed full time during at least 39 weeks of the 52 weeks immediately following his arrival at the new place of work.

Both the old and new residence must be in California.

D. Rationale:

The mobility of labor is an important and necessary part of a dynamic full employment economy. Substantial moving expenses are incurred by taxpayers in connection with employment related moves and these expenses are widely viewed as a cost of earning income.

V. FOSTER CHILDREN (AB 1000, Sec. 49)

A. Proposal: Allow foster children to qualify as a dependent

B. Fiscal Implication:
Minor revenue loss

C. Present Law:
State law now provides that a foster child does not qualify as a dependent

D. Rationale:
Foster children are treated in every way as part of a family unit and a credit for such children should be allowed to recognize costs of care of such children.

VI. DEDUCTIBILITY OF TREBLE DAMAGES, FINES, PENALTIES (AB 1000, Sec. 55; AB 1001, Sec. 81)

A. Proposal:
(1) Provide fines and penalties are not deductible business expenses
(2) Prohibit deduction of moneys paid for bribes of public officials and "kickbacks"
(3) Prohibit deduction as a business expense 2/3 of treble damage payments under the anti-trust laws.

B. Fiscal Implication:
Revenue gain; unknown amount

C. Present Law:
Present law is unclear whether fines and penalties are deductible; however, treble damages are now fully deductible as business expenses

D. Rationale:
By allowing a deduction for treble damages, the State allows a business to mitigate the penalty provisions of the anti-trust laws and is in the curious position of, in effect, paying a portion of the anti-trust judgment through foregone tax revenue.

VII. ACCUMULATION AND MULTIPLE TRUSTS (AB 1000, Sec. 92-104)

PRESENT LAW:

Single Accumulation Trust:

Presently, the law treats the trust as a separate entity which is taxed in the same manner as an individual. The important difference is that trusts are allowed to deduct from taxable income any distributions of ordinary income made to beneficiaries. The beneficiaries then include these distributions in their income for tax purposes. Therefore, in the case of income distributed currently, the trust merely acts as a conduit through which the income passes to beneficiaries, and the income retains the same character in the hands of the beneficiaries as it does in the hands of the trust. However, a trustee may be required or able to accumulate the income for the benefit of the beneficiaries and to this extent the income is taxed at individual rates to the trust.

When the trust distributes accumulated income to the beneficiaries, they are sometimes taxed under the throwback rule. This rule treats the income for tax purposes as if it had been received by the beneficiary in the year in which it was received by the trust (i.e., the beneficiary must compute the current tax as if the income had been received by him in the year the income was earned by the trust). However, the beneficiary is taxed under this rule only on the portion of the distribution that was earned by the trust in the five years immediately prior to the distribution. In addition to this limitation, the throwback rule does not apply to several types of distributions. If the accumulation distribution falls within one of these exceptions, the throwback rule does not apply and the trust rather than the beneficiary is taxed on this income.

Multiple Accumulation Trusts:

Present law permits, in some cases, the creation of multiple trusts by the same taxpayer for the same beneficiary. The effect of multiple accumulation trusts is to split income among several taxable entities, thereby achieving taxation at lower rates to each trust.

Capital Gains Income Treatment:

Also, if the trust has capital gains income, these gains are generally taxed to the trust in the year earned and there are no further tax consequences upon the distribution of these gains in later years.

Trusts, Special Circumstances:

In the case of a trust established by the taxpayer for the benefit of someone else, present law provides that the taxpayer creating the trust is to be treated as the <u>owner</u> of the trust generally if the trust income <u>can</u> be distributed to the taxpayer himself or can be used to his benefit now or in the future. In such cases, the trust income is taxable to the taxpayer as earned and not to the trust or the named beneficiaries.

PROPOSAL:

Single and Multiple Accumulation Trusts:

This proposal conforms California law to the changes made in the Federal Tax Reform Act in connection with single or multiple trusts and trusts of the benefit of a spouse.

This measure substantially reduces the tax savings that result from shifting income to one or more trusts and not making distributions to beneficiaries. This is accomplished by taxing beneficiaries as income is earned by the trust. The proposed measure achieves this effect by eliminating the five-year limitation and all the exceptions to the throwback rule, and providing instead an unlimited throwback rule with respect to the accumulation distributions, whether from one or more trusts.

The tax on the amounts so determined to be includible in the taxpayer's income may generally be computed in either of two ways, with credits allowed for the taxes paid by the trust(s) in prior years. A first-in, first-out rule is applied to determine which years the income was accumulated by the trust for purposes of "throwing back" the accumulation under the new unlimited throwback rule. The beneficiary's tax liability can be computed either by the exact method, which is substantially the same as the current method, or by the "shortcut" method which allows the taxpayer to use a three-year averaging method of computing the additional liability.

Capital Gains Income Treatment:

The proposal substantially changes the treatment of capital gains treatment. The accumulation trust distributions would retain the same income character to the beneficiary as they had in the hands of the trust(s). In essence, this means that a distribution of capital gains income would be treated as such to the beneficiary: the beneficiary would be taxed separately on such amount as if the capital gains were his own. An unlimited throwback rule also applies to capital gains and a distribution is determined to be one of capital gains to the extent that the distribution is greater than all of the accumulated ordinary income. (NOTE: If a distribution is greater than both the accumulated ordinary income and capital gains income, to that extent it is considered to be a distribution of corpus and no additional tax will be imposed.)

Trusts, Special Circumstances:

In the case of a trust as described under this subheading, "Present Law", the new law provides that the income of a trust is taxable to the creator of the trust if the trust income can be distributed to this taxpayer <u>or his spouse</u> or if the income can be used to benefit him <u>or his spouse</u> now or in the future. This provision does not apply if the beneficiary spouse is required to include the trust income in his or her own gross income. This provision is usually referred to as the treatment of "trust income for the benefit of spouse".

FISCAL IMPACT:

The estimated revenue gains are as follows:

Income year	Millions $
1970	.2
1971	.6
1972	.8
1973	1.0
1974	1.3
1979	2.7

Note: Initial revenue gains are small due to provisions of the act that delay the effective date for trusts making distributions from income accumulated in prior years. Only after December 31, 1973, will the new rules apply to all trusts and even then only to accumulations made after December 31, 1973. This delayed impact is desirable as it allows the taxpayer to maintain the necessary records for future tax years.

RATIONALE:

General: When a trustee has the discretionary power of distributing trust income now or in the future, he can elect to make such distribution at a time when the beneficiary is in a low income tax bracket. The progressive rate structure is thus avoided by deferring the distribution from the trust to the beneficiary. This means that the income in question is taxed to the trust at the starting tax rate instead of to the beneficiary at his marginal tax rate. The throwback rule theoretically prevents this result, but the five-year limitation and the numerous exceptions seriously erode effective taxation of the trust income at the beneficiary's marginal rate. This avoidance device is compounded by the use of multiple trusts (the creation of more than one accumulation trust by the same grantor for the same beneficiary). Multiple trusts may be used to split the income among several trusts, thus reducing the applicable tax rate substantially.

For these reasons, the new tax provisions eliminate the five-year limitation and the numerous exceptions to the throwback rule with respect to an accumulation distribution. For future accumulations, all deferred income distributions would be taxed to the beneficiary upon distribution to him and the amounts would be treated as if they had been distributed to the beneficiary in the years in which the income was accumulated by the trust.

Capital Gains Income Treatment:
The purpose of the new provisions in regard to capital gains income treatment is to close a significant loophole in the present law that allows the trust to be taxed currently on capital gains and further permits such gains to be distributed in later years with no additional tax to the beneficiary. The new measure will reduce the extent to which capital gains income is taxed to the trust at low rates, instead of to a beneficiary at high rates.

Trusts, special circumstances:
The purpose of the new treatment for trusts deemed created for the benefit of spouse is to treat husband and wife as a single economic unit.

VIII. UNRELATED BUSINESS INCOME OF TAX EXEMPT ORGANIZATIONS (AB 1001, Sec. 44-49, 64, 66, 67, 85)

A. Proposal: Extend corporation income tax to unrelated business income of all exempt organizations

B. Fiscal Implication:
Revenue gain; unknown amount

C. Present Law:
The present state law imposes the unrelated business income tax on a number of tax exempt organizations -- such as churches, labor, agricultural and horticultural organizations, schools, charitable organizations, business leagues, etc.

Such organizations still exempt are social clubs, fraternal beneficiary societies, civic leagues, organizations of employees.

D. Rationale:
The issue here is tax neutrality and tax equity. When an organization engages in a business as a profit-making activity unrelated to the exempt organization -- it has a competitive advantage over like businesses which are subject to income taxes. The tax structure should be neutral with respect to business organizations and competition. In addition, it is hardly equitable to tax, for example, total income of a hospital or church and exempt the same for a civic league.

IX. INVESTMENT INCOME OF CERTAIN TAX EXEMPT ORGANIZATIONS (AB 1001, Sec. 53)

A. Proposal: Extend the unrelated business income tax to investment income of social, fraternal and similar organizations

B. Fiscal Implication:
Revenue gain; unknown amount

C. Present Law:
Investment income of social, fraternal and similar organizations are tax exempt

D. Rationale:

Since the tax exemption for social clubs and other groups is designed to allow individuals to join together to provide recreational or social facilities or other benefits on a mutual basis, without tax consequences, the tax exemption operates properly only when the sources of income of the organization are limited to receipts from the membership.

Under such circumstances, the individual is in substantially the same position as if he had spent his income on pleasure or recreation without the intervening organization.

However, when the organization receives income from sources outside the membership, such as income from investments, upon which no tax is paid, the membership receives a benefit not contemplated by the exemption in that untaxed dollars can be used by the organization to provide pleasure or recreation to the membership.

X. MINERAL PRODUCTION PAYMENTS (AB 1000, Sec. 87; AB 1001, Sec. 96)

A. Proposal:

(1) Treat a carved-out mineral production payment as a mortgage loan on the mineral property rather than an economic interest in the property.

(2) Treat a production payment on the retained sale of a mineral property as a purchase money mortgage rather than an economic interest in the mineral property.

B. Fiscal Implications:

State revenue gain:
1970 - $2.3 million
1971 - $2.6 million

C. Present Law:

A carved-out production payment is created when the owner of a mineral property sells -- or carves out -- a portion of his future production. A carved-out production payment is usually sold for cash and, quite often, to a financial institution. Under present law, the amount received by the seller of the carved-out production payment generally is considered ordinary income subject to depletion in the year in which received. The purchaser of the production payment treats the payments received as income subject to the allowance for depletion (almost always cost depletion) and thus generally pays no tax on those amounts (except for that portion of the payments which is in the nature of interest). The amounts utilized to pay the production payment are excluded from income by the owner of the property during the payout period, but the expenses attributable to producing the income are deducted by him in the year they are incurred.

A retained production payment is created when the owner of a mineral interest sells the working interest, but reserves a production payment for himself. Under present law the owner of the retained production payment receives income for which percentage depletion may be taken during the payout period, or period during which he receives a part of the production (or a payment based on production). The purchaser of the working interest excludes the amounts used to satisfy the production payment during the payout period, but (until recently) deducted the cost of producing the minerals subject to the production payment.

D. Rationale:

Mineral production payments are transactions which, in fact, are very similar to loans. In a carve-out, the analogy to the loan is the borrowing of money. In the retained production payment, the analogy is to the sale of a property subject to a mortgage. While the factual similarities are readily apparent, the tax treatments are quite different -- the mineral production payment system substantially reduces tax liabilities by the avoidance of limits on depletion deductions and mismatching of income and expenses which creates artificial tax losses.

There is no reason why a person who, in effect, is the borrower in a production payment transaction should be allowed to pay off the loan with tax free dollars while a borrower of funds in any other industry must satisfy the loan out of taxed dollars.

The factual similarity between the creation of a production payment and a loan transaction and the disparate tax treatment of production payments and loans can be illustrated by examining two hypothetical A-B-C transactions, one involving an oil payment, and the other the sale of an apartment.

Assume that A sells an operating business to B -- the business may be an oil well, or may be an apartment building. However, assume that A retains the right to a production payment -- a payment equivalent to the current price of a specified number of barrels of oil -- or in the case of the apartment building, a mortgage, which is not much different from the production payment. Then suppose that A sells the production payment or mortgage to C.

From A's standpoint, the two transactions are treated the same -- they both result in a capital gain -- or loss -- to A depending upon his cost or other basis whether it is the apartment building or oil well which is being sold.

However, the similarity between the oil well and the apartment building ends here. In the case of the apartment building, all of the rental income after ordinary expenses and depreciation is taxable income to B and he must pay off the mortgage out of "after tax" dollars.

In the case of the oil well, however, B is not considered as receiving the production payment at all -- which, in the typical case, may well amount to as much as 90 percent of the income from the well. Thus, in this case B is, in effect, paying the production payment out of "before tax-dollars". This privilege of paying off capital interests out of tax free dollars is not a privilege accorded ordinary taxpayers.

XI. UNLIMITED CHARITABLE CONTRIBUTION

A. Proposal: This measure would reduce by 1975 the presently unlimited charitable deduction to 50% of a taxpayer's taxable income. The reduction is accomplished gradually in the years 1970-1974. For the first taxable year affected, the unlimited deduction can't reduce the taxpayer's taxable income to less than 20% of his adjusted gross income.

At the same time, the measure reduces the percent of income necessary to qualify for the unlimited deduction from 90% in 1970 to 50% in 1975. The bill also conforms California to federal law in requiring the taxpayer to meet this percentage test in only eight out of ten preceding years in addition to the taxable year, rather than the current ten out of ten preceding years currently required.

B. Present Law:

Present law generally allows taxpayers to deduct charitable contributions up to 20% of the taxpayer's taxable income.

However, the law also provides that if a taxpayer's charitable contribution and income taxes exceed 90% of his income for the taxable year and in each of the 10 preceding taxable years, the 20% limit does not apply.

C. Fiscal Implication:

Minor revenue gain

D. Rationale: The current provisions allow a very few high income taxpayers to minimize or avoid tax liability by means of the charitable contribution deduction. The reduction of the limitation to 50% would require the taxpayer to include at least 50% of his gross income in his tax base.

XII. LIMITATION ON DEDUCTIBILITY OF INVESTMENT INTEREST (AB 1000, Sec. 56)

A. Proposal: This measure limits the deductibility of investment interest by non-corporate taxpayers in taxable years beginning in 1972 (until then, excess investment interest is classified as a tax preference item and subject to the 1.5% minimum income tax). Investment interest, defined as interest paid or accrued on indebtedness or continued to purchase or carry property held for investment, can be used only to offset specified income items. These items are:

(1) $25,000
(2) Net investment income
(3) The excess of net long-term capital gain over net short-term capital loss
(4) one-half of the excess of investment interest over the total of the three items above.

Investment interest that is disallowed in one year may be carried over to the next year. The amount that can be deducted in the following year is limited to one-half of the net investment income for the carryover year plus $25,000 over the greater of:

(1) investment interest paid in the carryover year or
(2) $25,000.

If, because of these requirements, part of the investment interest is disallowed, it may be carried over to a third year, reduced by the amount of capital gains not recognized. Special rules and exceptions are applied in the case of property under net lease, partnerships, construction interests, and binding contracts.

B. Fiscal Implication:
Estimated revenue gain of $.5 million in 1972 and following years.

C. Present Law:
Under present law, all interest paid or incurred can be claimed as an income tax deduction.

D. Rationale:
Although this provision will have only limited impact due to its restricted application, conformity is probably desirable in terms of the principle at issue.

Some taxpayers deliberately incur large interest expenses on funds borrowed for investment in order to offset the costs of carrying the investment property which currently produces little or no income. Often, the interest expense also offsets ordinary income to a large extent.

The expectation is that the eventual sale of the investment property will result in a long-term gain while the costs of carrying the asset have been entirely offset. To discourage this practice, the measure attempts to limit the deductibility of interest in these cases by requiring that the interest expense be offset against specified types of income.

XIII. STOCK REDEMPTION BY CORPORATION WITH APPRECIATED PROPERTY (AB 1001, Sec. 91)

A. Proposal: This provision changes the tax treatment of appreciated property redemptions made after November 30, 1969 in conformity with the Federal changes. If appreciated property is used to redeem all or part of a stockholder's stock, the corporation must pay tax on any appreciation in value of the property, as measured by fair market value over adjusted basis, that is used to make the redemption. This provision applies to all redemptions, even if classified as a dividend; but does not apply to a complete or partial liquidation of a corporation.

B. Fiscal Implications:

Although detailed estimates are not available, a substantial revenue gain is expected.

C. Present Law:

Presently, a corporation that is holding stock of another corporation that has appreciated in value can use this appreciated stock to redeem a portion of its own stock without paying tax on the gain in value.

D. Rationale:

Present law allows corporations to redeem substantial amounts of their own stock with appreciated property and in this manner allows these corporations to dispose of appreciated property in essentially the same manner as if they had sold it and then redeemed their own stock. However, dispositions made in this manner are not now subject to tax on appreciation in value. The present treatment has, in essence, created a loophole that corporations may use to avoid taxes on the appreciated value of property that would be owed on any other sort of disposition. This loophole is utilized to a large extent by corporations which hold large investment portfolios of stock of other companies acquired some time ago at much lower than present value.

XIV. DEBT FINANCED CORPORATE ACQUISITIONS AND RELATED PROBLEMS:

Fiscal Implications: If all five items are adopted, the total estimated revenue increase is as follows:

Income Year	
1970	$ .1 (millions)
1971	.1
1972	.2
1973	.3
1974	.3
1979	.5

Item 1. Interest on Indebtedness Incurred by a Corporation to Acquire the Stock or Assets or Another Corporation. (AB 1001, Sec. 86)

A. Proposal: This proposal limits the amount of corporate interest deduction allowed on "corporate acquisition indebtedness" incurred after Oct. 9,1969 to acquire stock or two-thirds of all the operating assets (excluding cash) of another corporation. The maximum amount of such interest to be allowed as a deduction is $5 million, reduced by any interest incurred on indebtedness issued any time after 1967 used to acquire corporate stock or operating assets, but which does not qualify as corporate acquisition indebtedness.

In order to be "corporate acquisition indebtedness", a bond, debenture, note, certificate, or other evidence of indebtedness has to be used to pay for, directly or indirectly, the purchase of stock or not less than 2/3 of the operating assets of another corporation. An obligation used to acquire less than 5% stock interest in a corporation does not qualify as acquisition indebtedness. In addition to qualify as acquisition indebtedness, the debt instrument must come under <u>all</u> of the following debt-equity tests:

(1) Subordination to other Creditors: the debt instrument must be subordinated either to the claims of the issuing corporation's general creditors or to any substantial amount of the corporation's unsecured indebtedness (whether outstanding now or at a later time).

(2) Convertibility Test: the debt instrument must be convertible, directly or indirectly, into the stock of the issuing corporation. This requirement is satisfied if stock purchase warrants to purchase the issuing corporation's stock are issued along with the debt instrument.

(3) Ratio of Debt-to-Equity or Earnings Test: the debt instrument must come under <u>either</u> the debt-to-equity or earnings test. The test date is the last day of the issuing corporation's taxable year in which a debt instrument was used to purchase another corporation's stock or operating assets.

(a) Debt-to-Equity: the ratio of the acquiring corporation's debt to its equity is determined by comparing the corporation's total indebtedness to the <u>excess</u> of its money and other assets over that indebtedness (i.e., equity). The assets are accounted for at their adjusted basis for this purpose. If the ratio <u>exceeds</u> 2 to 1 (i.e., the amount of debt is over two times the amount of equity), the test is considered met.

(b) Earnings Test: this test is computed by comparing, on the test date, the issuing corporation's average annual earnings for the previous three years (called projected earnings) with the corporation's annual interest costs on its total outstanding indebtedness. If the annual interest costs are not covered at least three times over by the average annual earnings, the earnings test is considered met.

As a general rule, once the tests described above are satisfied so as to result in the disallowance of a deduction for the interest with respect to the obligation for a taxable year, the interest deduction will be disallowed for that year and all subsequent years. The measure provides that in the instance where the issuing corporation subsequently obtains control of another corporation, the projected earnings and annual interest expense of both corporations are taken into account for purposes of computing the equity test. The following exception is also made to the general disallowance rule: if a corporation issuing corporate acquisition indebtedness does not meet the debt-equity and earnings tests for each of three consecutive taxable years, the interest deduction limit imposed on those obligations ceases to apply, beginning with the first taxable year after the three-year period.

This proposal also includes special rules for applying such tests to financial institutions and for treating all members of affiliated groups as one entity.

B. Present Law:

A corporation at this time can deduct interest paid by it on its debt but is not allowed a deduction for dividends paid on its stock or equity. Present rules for distinguishing equity interests and debt interests are not clear.

C. Rationale:

Because the present regulations are not clear in distinguishing between debt versus equity interests this measure provides for specific tests to make such a determination within a limited context. Item 5, following, also allows the Franchise Tax Board to establish regulations to make this determination in other situations. Although the problem is a long standing one, it has become even more significant in recent years because of the increasing number of corporate mergers and the increasing use of debt for corporate acquisition purposes.

There are a number of factors which make the use of debt for corporate acquisition purposes desirable, including the fact that a corporation can deduct dividends on stock. A number of these factors also tend to make the bond or debenture more like an equity interest in spite of the fact that it is labeled as debt. For example, the fact that a bond is convertible into stock makes it more desirable as it allows the bondholder to participate in the growth of the company. The fact that a bond is subordinated to other creditors makes it more desirable since it does not impair the corporation's general credit position.

The conclusions reached by those who have studied this proposal at the federal level were that even though a corporate obligation is labeled debt, it should be treated for tax purposes as an equity interest if, in fact, the obligation is more like an equity than a debt interest. The tests required by this measure attempt to make that determination and consequently limit the interest deduction if the tests are met and the interest is, therefore, concluded to be primarily an equity interest.

Item 2. Installment Method (AB 1000, Sec. 72; AB 1001, Sec. 94)

A. Proposal: This measure provides that for purposes of the installment method of reporting gains on sales of real property and casual sales of personal property, certain types of indebtedness are to be treated as payments received in the year of sale and thus subject to the 30% rule. The types of indebtedness to be treated in this manner include bonds or debentures with interest coupons attached, in registered form, or in any other form designed to make such securities readily marketable. Such treatment is also extended to include bonds that are payable on demand as well as other evidence of indebtedness issued by a corporation or other governmental body. Ordinary promissory notes are not intended to be included.

This provision applies to sales or other dispositions made after May 27, 1969,but does not apply to those made under a binding contract entered into on or before May 27, 1969.

B. Present Law:

Under present law, a taxpayer may elect the installment method of reporting a gain on sale of real or personal property if the price is in excess of $1,000 and if the payments received by the seller in the year of sale do not exceed 30% of the sales price. Originally, installment reporting was allowed to ease a possible hardship if the taxpayer did not receive sufficient cash in the year of sale to pay the tax in that year.

C. Rationale:

In essence, the reason for this provision is that there is no reason for postponing gain where a seller of property receives something which is the equivalent of cash. Reporting gain on the installment method when debentures or other readily marketable securities are received by the taxpayer is not consistent with the intent of the installment provisions.

Item 3. Bonds and Other Evidences of Indebtedness (AB 1000, Sec. 114-5)

A. Proposal: This measure provides that the bondholder and the corporation issuing the bond are to be treated in a consistent manner with respect to the original issue discount on the bond. This bill requires the bondholder to include in his income a ratable portion of the orignal issue discount over the life of the bond. As he includes the original issue discount in income, his basis for the bond would be correspondingly increased. If a bondholder sells the bond prior to maturity, he would be treated as receiving capital gain based on his adjusted basis for the bond unless there was an intention to call the bond before its maturity when it was originally issued, in which case the gain on sale would be treated as ordinary income to the extent of the full amount of original issue discount.

This ratable inclusion is not required of persons who purchased a bond at a premium. Also, these rules are not to apply to bonds or other evidences of indebtedness issued by any government or political subdivision.

Effective on discounts after May 27, 1969.

B. Present Law:

Original issue discount is the difference between the issue price and the face amount of the bond, when the price is less than the face amount, if the bond is a capital asset in the hands of the person acquiring it. Under present law the owner of the bond is not taxes on the original issue discount until the bond is redeemed, sold or otherwise disposed of. On the other hand, the issuing corporation amortizes the amount of the original issue discount over the life of the bond (i.e., is allowed as current deduction).

C. Rationale:

The present treatment results in a nonparallel treatment of the corporation issuing the bond and the person acquiring the bond. Reportedly, taxpayers often neglect to include the original issue discount as a gain when they dispose of the bond and also neglect the fact that this portion of the gain is as taxable as ordinary income, not capital gains. The present laws may provide the effect of the original issue discount never being taxed to the bond owner. Many also maintain that this treatment of original issue discount is another reason why corporations use bonds to acquire another corporation.

Item 4. <u>Limitation on Deduction of Bond Premium on Repurchase</u> (AB 1001, Sec. 87)

A. Proposal: This provision clarifies a controversy on whether the premium that a corporation must pay to repurchase its own convertible indebtedness is fully deductible by stating that it is not. A deduction will be allowed only for the amount of a normal call premium for nonconvertible indebtedness. The measure further provides that a larger deduction will be allowed if the corporation can demonstrate to the FTB that the amount of the premium in excess of that otherwise allowed as a deduction is related to the cost of borrowing and not to the conversion feature of the indebtedness.

Applies to repurchases after April 22, 1969.

B. Present Law:

At this time, there is a question as to whether a corporation which repurchases its own convertible indebtedness at a premium may deduct the entire difference between the stated redemption price at maturity and the actual repurchase price. Several IRS rulings have been contradicated by the courts.

C. Rationale:

In clarifying this controversy, the federal government declared that the amount of the premium which is in excess of the cost of borrowing is not similar to an interest expense or deductible business expense, but rather is similar to an amount paid in a capital transaction. In essence, the corporation is repurchasing the right to convert the bonds into its common stock, much as it might purchase its stock.

Item 5. Treatment of Certain Corporate Interests as Stock or Indebtedness
(AB 1000, Sec. 66; AB 1001, Sec. 93)

A. Proposal: The bill authorizes the FTB to prescribe the necessary factors to be considered in distinguishing debt and stock interests (i. e., whether the relationship is one of debtor-creditor or corporation-shareholder).

B. Present Law:
The present rules defining such relationships are somewhat unclear in spite of the significant tax consequences that can result.

XV. DEBT FINANCING OF ACQUISITIONS BY TAX EXEMPT ORGANIZATIONS: THE CLAY BROWN RULE (AB 1001, Sec. 67)

A. Proposal: Extend unrelated business income tax to "unrelated debt-financed income" received by a tax-exempt organization -- in proportion to the debt existing on the income producing property. In other words, if a property is worth $100,000 and $50,000 in debt was used to acquire the property, 50% of the income from the property will be treated as unrelated business income.

Excluded from these provisions are:

(1) any property if substantially all the use is substantially related to the organization's exempt function.

(2) any property to the extent that its income is subject to tax as income from the conduct of any unrelated trade or business.

(3) any property to the extent that its income is derived from research activities and is excluded from gross income of an unrelated trade or business.

(4) any property to the extent it is used in a business where

 (a) substantially all of the work is performed without compensation

 (b) the organization carrying on the business does so primarily for the convenience of members, students, patients, etc.

 (c) the business consists of selling merchandise substantially all of which has been received as contributions.

(5) real property located in the neighborhood of other property owned and used for exempt purposes which will be used for an exempt purpose within ten years.

B. Fiscal Implications:

Minor revenue gain

C. Present Law:

The present unrelated business income tax does not apply to income from the leasing by a tax exempt organization of the assets constituting a going business.

D. Rationale:

Present tax law permits a "bootstrap" sales and leaseback transaction which allows owners of businesses to convert ordinary income into capital gains and allows tax exempt organizations to acquire businesses entirely from the earnings of the business.

For example: The sole stockholders of a closely-held corporation sell their stock to an exempt organization for $1,300,000. The exempt organization makes a "bootstrap" purchase -- no down payment and a promissory note executed for the balance of the purchase price to be paid only from the earnings of the company's assets. At the same time, the exempt organization liquidates the corporation and leases its assets for a period of five years to a new company formed by the stockholders' attorneys. Under terms of the lease, the new company is to pay the exempt organization 80% of its operating profit as rent. The exempt organization, in turn, pays 90% of the rents received to selling stockholders to be applied on the promissory note.
(Clay Brown, 380 U.S. 563)

Thus, through the use of the tax exempt devise, stockholders increased after tax income and the tax income and the tax exempt organization acquired a $1.3 million business without investment of its own funds.

XVI. NON-EXEMPT MEMBERSHIP ORGANIZATIONS: LIMIT ON DEDUCTIONS (AB 1001, Sec. 85)

A. Proposal: Limit deduction for the cost of furnishing services, goods, insurance, etc. to members of non-exempt social clubs to the extent of income (dues) from members.

B. Fiscal Implications:
Minor revenue gain

C. Present Law:
Taxable membership organizations are permitted to apply income from non-members and from commercial activities against cost of services furnished members.

D. Rationale:
In some cases, membership organizations which also have business or investment income, serve their members at less than cost and offset this book loss against their business investment income and as a result, pay no income tax. The recipients of such services also pay no income tax on such services and, in effect, have received something of value that others have to purchase with after-tax dollars.

XVII. TAX-EXEMPT ORGANIZATIONS: INCOME FROM ADVERTISING (AB 1001, Sec. 66)

A. Proposal: Include in the definition of "trade or business" any activity carried on for the production of income from the sale of goods or the performance of services. An activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities.

Under this provision, the Congress anticipates that advertising income from any publication of an exempt organization will be unrelated business income to the extent that it exceeds expences and editorial losses.

Organizations with multiple publications may consolidate gains and losses for the purposes of this provision.

B. Fiscal Implications:
Minor revenue gain

C. Present Law:
There is some dispute as to whether the acceptance of paid advertising in an exempt publication is an unrelated business.

D. Rationale:
The statutory language on which the present interpretations that net income from advertising is to be included as unrelated business income is sufficently unclear as to invite substantial litigation. The proposal seeks to eliminate an unfair competitive advantage that publications of tax exempt organizations have over other publishers.

XVIII. VOLUNTARY EMPLOYEE BENEFICIARY ASSOCIATIONS
(AB 1001, Sec. 44)

A. Proposal: Eliminate the present requirement that 85% of the income of a voluntary employee beneficiary association consist of amounts collected by members and amounts contributed by members' employers for the sale purpose of making payments of life, sickness, accidents, and other benefits.

B. Fiscal Implications:
None

C. Present Law:
Voluntary employees' beneficiary associations providing life, sickness, accident, or other benefits must derive 85% of its income from its members.

D. Rationale:
With the imposition of the tax on unrelated business income on organizations in this category, the 85% income test is no longer necessary. As a result, the requirements are substantially the same as the qualification standards for employee associations of Federal employees.

XIX. FEEDER ORGANIZATIONS (AB 1001, Sec. 48)

A. Proposal: Extends to "feeder organizations" the beneficial exceptions of the unrelated business tax. The unrelated business income tax does not apply to a feeder organization in which substantially all the work in carrying on the business is performed by the organization without compensation or to the operation by a feeder organization of a business of selling merchandise -- most of which is received as gifts and contributions.

B. Fiscal implication:

Very minor revenue loss

C. Present law:

Under present law, feeder organizations (organizations which feed all profits to tax exempt organizations) operated primarily to carry on a trade or business for profit are not exempt from taxation.

D. Rationale:

A business operated by an exempt organization through a separate entity should not be subject to tax if the business would be exempt from tax if operated directly by the exempt organization.

XX. LUMP-SUM DISTRIBUTIONS FROM EMPLOYEES' PLANS (AB 1000, Sec. 53)

A. Proposal: In regard to a lump-sum distribution to an employee of the total amount due him from a qualified pension, profit-sharing, or stock bonus plan, this measure would provide capital gains treatment only for the difference between the taxable portion of the distribution and the employer's contributions. In essence then, the employer's contributions are taxed as ordinary income subject to a revised ceiling.

This measure also revises the ceiling placed on the tax due from the portion of the distribution that is treated as ordinary income. The ceiling is the greater of:

(1) 7 (rather than the current 5) times the increase in tax resulting from including 14 2/7% (rather than the current 20%) of the ordinary income portion of the distribution in the employee's gross income, or

(2) 7 times the increase in tax which would result if taxable income equalled 14 2/7% of the ordinary income portion of the distribution less personal exemptions.

B. Present Law:

The entire taxable portion of such a lump-sum distribution is eligible for capital gains treatment if the distribution is received in one taxable year of the employer. But, if the benefits are received as an annuity, the employee is taxed on the portion that exceeds his own contributions(i.e., the employer's portion) as ordinary income.

C. Fiscal Implications:

Minor revenue gains

D. Rationale:

Present law treats distributions differently if they are received in total in one year in order to avoid the "bunched" income problem. However, by allowing capital gains treatment for the entire taxable portion the loss is providing preferential treatment for amounts that really consist of deferred compensation, (i.e., the amounts that the employer contributes).

Also, it appears that the most significant benefits accrue to taxpayers with adjusted gross income of over $50,000. Highly paid employees would often prefer to convert current income into deferred compensation in an attempt to avoid high marginal rates.

Reform in this area is primarily an attempt to treat taxpayers similarly when they are situated in a similar manner -- in this instance, to treat them similarly whether they receive distributions in one year or in several. The ceiling on the tax for the portion taxed as ordinary income is an attempt to avoid undue hardship because of this revised treatment.

EDUCATIONAL EQUALIZATION TAX (AB 1000, See Index)

A. Proposal:

1. Levy a $2.05 statewide property tax on all taxable property to replace the first $2.05 levied locally by school districts.

2. Require the State Board of Equalization to adjust this tax rate to compensate for variations in county assessment levels.

3. Allocate all the funds produced by such a tax back to school districts.

B. Fiscal Implications:

1. The $2.05 statewide property tax will produce new revenue of $60 million, from basic aid school districts, and provide for an additional $12 million per ADA increase in state support.

C. Present law:

The only statewide property tax now levied by the state is one on private railroad cars. This is levied by the State Board of Equalization on the assessed value of such cars using last year's average statewide property tax rate. The proceeds from this tax go to the general fund.

D. Rationale:

1. The State of California has an obligation to see that all children have an equal opportunity to have an adequate education.

2. Among the districts of the state, there is a wide variation in the local ability to support an educational program.

Assessed Value per ADA
1968-69

	Elementary	High School
Low	$ 125	$ 10,350
Average	14,723	35,247
High	1,156,872	339,362

3. The present system of support does not provide reasonable uniformity of tax effort by taxpayers

4. The $2.05 statewide property tax reduces the program ratio from 3.4 times to 2.2 times.

Equalization to be accomplished

Present Law		Ratio
Baldwin Park	$ 533	1
Beverly Hills	1794	3.4
Statewide Tax at 2.05		
Baldwin Park	$ 545	1
Beverly Hills	1200	2.2

5. It is best to institute a statewide property tax in connection with a major tax reform program. In AB 1000 and 1001, the property tax rate in most "adversely effected" school districts is still lower than present rates due to the rate reductions which stem from the state assuming much of the county's welfare financing.

   In addition, in all school districts, every homeowner will see a reduction in property taxes due to the increase in the homeowners' exemption.

EXPENDITURE LIMITS (AB 1000, Sec. 33)

A. Proposal: (1) Schools

(a) Expenditures for current expenses per ADA for each school district are limited to the amount authorized to be spent in the prior year per ADA plus a factor for growth (the factor is the percentage increase in the services index of the consumer price index). The limits can be exceeded by 1% for unexpected emergencies if approved by the county board of education. The limit may be increased by a vote of the people.

(b) For other than current expense (food services, community services, capital outlay), a tax rate limit is established at the level which is the same proportion of present non-current expense to total tax rate. The limits are:

Elementary	.13
High School	.08
Unified	.21
Junior College	.06

(c) Districts are allowed to levy a tax rate to retire bonds and repay state building loans.

(d) Existing tax rate limits and authorized permissive overrides are repealed.

(2) Counties

(a) Current expenses (excluding public assistance) per capita by each county are limited to the prior year's current expenditures per capita plus a factor for growth (the factor is the percentage increase in the services index of the consumer price index). The limit may be exceeded by 1% for unexpected emergencies by a unanimous vote of the supervisors. The limit may be increased by a vote of the people.

(b) Expenditures by counties for public assistance are limited to the prior year's expenditures plus a factor for growth (the factor is the average percentage increase in public assistance expenditures for the prior three years). This limit may be exceeded by 1% for unexpected emergencies by a unanimous vote of the supervisors. If the supervisors believe that this limit will endanger the peace, health, or safety of the county's residents or prohibits expenditures required by law, they may request the State Director of Social Welfare for an increase in the limit.

(c) By a unanimous vote, the supervisors may levy any tax rate to pay for fixed asset.

(d) Counties are authorized to levy a tax rate necessary to retire bonds.

(3) Cities

(a) Before cities can expend money from any new permissive tax override authorized by the legislature, they must provide local residents the right to subject such override to a referendum upon signatures of 20% of the registered voters.

B. Fiscal Implications:

These provisions effectively limit the extent to which counties and school districts may levy property tax rates.

C. Present Law:

At the present time, counties are not subject to expenditure or tax rate limits. Schools are not subject to crude tax rate limits, with a number of exceptions.

D. Rationale:

(1) Expenditure limits guarantee that property tax reductions provided by this program will not be consumed by higher local spending. The limits, however, allow flexibility for local government to meet legitimate growth demands.

(2) Tax rate limits are no good. They have been ineffective in controlling property tax increases. They are inequitable because the same limits produce vastly more in dollars per pupil in one school district than another. They allow the spending of any large"windfall" increase in assessed value due to changes in assessment levels, while prohibiting local government from meeting its responsibilities for existing programs where assessed values remain static.

(3) Data developed indicates expenditure limits, while being more rational limits, will also be more effective. Studies show that property tax levels for schools would not have accelerated so rapidly had an expenditure limit, rather than a tax rate limit, been in effect.

(4) Mechanically, expenditure limits are effective devices to insure that property tax rates are reduced when additional state funds are provided by local government. If expenditures are fixed, when the state share is increased, the local share must decrease. This automatically precludes the use of property tax relief money for additional spending.

ESTIMATED IMPACT OF GOVERNOR'S TAX PROGRAM
ON SINGLE INDIVIDUALS

HOMEOWNER

Income	Personal Income Tax: 11% & 12% Tax Rates	Personal Income Tax: Capital Gains	Personal Income Tax: Interaction of other changes	Personal Income Tax: Total Income Tax	Additional Sales Tax	Property Tax: Additional Homeowners Exemption	Property Tax: Reduced Welfare Tax	Total Net Change
Without Capital Gains								
$3,500	---	---	---	---	$15	-$61	-$5	-$51
5,000	---	---	---	---	20	-66	-6	-52
7,500	---	---	$3	$3	28	-84	-8	-61
10,000	---	---	4	4	35	-98	-10	-69
12,500	---	---	5	5	42	-102	-10	-65
15,000	---	---	9	9	47	-143	-15	-102
17,500	---	---	12	12	50	-158	-17	-113
20,000	$4	---	16	20	55	-177	-19	-121
25,000	84	---	22	106	61	-222	-25	-80
50,000	488	---	40	528	78	-370	-43	193
75,000	899	---	49	948	111	-466	-55	538
100,000	1,300	---	70	1,370	184	-682	-83	789
With Capital Gains								
$10,000	---	$8	$4	$12	$35	-$98	-$10	-$61
15,000	---	20	9	29	47	-143	-15	-82
20,000	$4	40	16	60	55	-177	-19	-81
25,000	84	63	22	169	61	-222	-25	-17
50,000	488	150	40	678	78	-370	-43	343
75,000	899	216	49	1,164	111	-466	-55	754
100,000	1,300	320	70	1,690	184	-682	-83	1,109

NOTE: Standard deduction used for single returns below $7,500. Average itemized deductions used otherwise.

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ESTIMATED IMPACT OF GOVERNOR'S TAX PROGRAM
ON MARRIED COUPLES WITH TWO CHILDREN

HOMEOWNER

Income	Personal Income Tax: 11% & 12% Tax Rates	Personal Income Tax: Capital Gains	Personal Income Tax: Interaction of other changes	Personal Income Tax: Total Income Tax	Additional Sales Tax	Property Tax: Additional Homeowners Exemption	Property Tax: Reduced Welfare Tax	Total Net Change
Without Capital Gains								
$5,000	---	---	---	---	$22	-$70	-$6	-$54
7,500	---	---	---	---	31	-82	-8	-59
10,000	---	---	$2	$2	39	-99	-10	-68
12,500	---	---	3	3	47	-120	-12	-82
15,000	---	---	4	4	54	-134	-14	-90
17,500	---	---	6	6	56	-152	-16	-106
20,000	---	---	8	8	62	-169	-18	-117
25,000	---	---	11	11	69	-208	-23	-151
50,000	$180	---	36	216	89	-346	-40	-81
75,000	617	---	43	660	126	-435	-52	299
100,000	1,020	---	61	1,081	209	-638	-77	575
With Capital Gains								
$10,000	---	$3	$2	$5	$39	-$99	-$10	-$65
15,000	---	5	4	9	54	-134	-14	-85
20,000	---	13	8	21	62	-169	-18	-104
25,000	---	20	11	31	69	-208	-23	-131
50,000	$180	86	36	302	89	-346	-40	5
75,000	617	154	43	814	126	-435	-52	453
100,000	1,020	251	61	1,332	209	-638	-77	826

NOTE: Standard deduction used for joint returns below $10,000. Average itemized deductions used otherwise.

1/30/70 (70/5)