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Internal Revenue Code Update
(General Fund Taxes -- Individual and Corporate Income and Franchise Taxes)

CURRENT LAW

State tax provisions are generally referenced to definitions under federal law. With limited exceptions, changes to federal law take effect for state purposes only after action by the Legislature. Each year, the Legislature reviews the previous year's federal law changes to update state references to the federal Internal Revenue Code (IRC). With exceptions, current state tax provisions reference the code in effect as of December 31, 1999.

GOVERNOR

No provision.

DISCUSSION POINTS

1. In a letter dated May 21, 2001, the administration requested that the Joint Committee on Finance incorporate an IRC update into the Committee's version of the budget. The majority of changes in federal law that affect the IRC were part of the Federal Sales Corporation Repeal and Extraterritorial Income Exclusion Act, the Community Renewal Tax Relief Act and the Installment Tax Correction Act.

2. The administration recommends that, beginning in tax year 2001, the state individual income and corporate and franchise income tax provisions referenced to the federal IRC would refer to the code in effect on December 31, 2000.

3. State references to federal law generally provide greater simplicity for taxpayers in

preparing returns and reduce the administrative burden and cost for both taxpayers and DOR in assuring compliance with tax laws. The IRC references are used to determine which items of income are subject to taxation prior to specific state modifications. The state uses separate tax rates and brackets and separate provisions regarding standard deductions, itemized deductions and tax credits.

4. The Department of Revenue estimates that the IRC update provisions would have a minimal effect on individual income tax revenues and would decrease corporate income and franchise tax revenue from businesses by $2.0 million in 2001-02 and by $2.95 million in 2002-03. The following table provides a summary of the corporate and business items that are estimated to have an impact on state revenues.

Summary of Federal Law Changes with Fiscal Effects
($ in Millions)

Corporate and Business	2001-02	2002-03
Environmental Remediation Costs	-$0.35	-$0.90
Corporate Donations of Computer Technology	-0.50	-0.60
Duplication or Acceleration of Loss Through Assumption of Certain Liabilities	0.10	0.10
Foreign Sales Corporations	-1.25	-1.55
Total	-$2.00	-$2.95

5. The following sections briefly describe the new federal provisions that would have a state fiscal effect. The Appendix identifies the other federal provisions that would be adopted, but are estimated to have a minimal state fiscal effect.

Environmental Remediation Costs

6. Extend the expiration date for the election to deduct certain environmental remediation expenditures that would otherwise be charged to a capital account to include expenses paid or incurred before 2004. The requirement that expenditures be in a targeted area is eliminated so that most other sites certified by state environmental agencies as containing hazardous substances are eligible.

This provision is effective for expenditures made after December 21, 2000. The estimated fiscal effect is a revenue decrease of $350,000 in 2001-02 and $900,000 in 2002-03.

Corporate Donations of Computer Technology

7. Extend the expiration date for deductions of certain computer equipment donated to elementary and secondary schools through 2003. The deduction is extended to include donations to

public libraries, donations of property up to three years after acquisition, rather than two years under prior law, and donations of property reacquired by a computer manufacturer.

This provision applies to donations made after December 31, 2000. The estimated fiscal effect is a revenue decrease of $500,000 in 2001-02 and $600,000 in 2002-03.

Duplication or Acceleration of Loss Through Assumption of Certain Liabilities

8. Require that the basis of stock received in certain tax-free exchanges be reduced by the amount of any liability assumed in exchange for the stock that does not otherwise reduce the transferor's basis. Stock cannot be reduced below its fair market value. The provision would generally not apply if the trade or business with the liability or substantially all of the assets associated with the liability is transferred to the corporation in the exchange.

This provision is effective for assumption of liabilities on or after October 19, 1999. The estimated fiscal effect is a revenue increase of $100,000 in 2001-02 and 2002-03.

Foreign Sales Corporations

9. Repeal the present foreign sales corporation (FSC) rules and replace them with an exclusion for extraterritorial income. The tax benefit under the exclusion is expected to mirror the tax benefit under the FSC rules, but apply to a greater number of taxpayers. Corporations could use the new benefit directly rather than having to create specifically defined FSC subsidiaries.

The law change is in response to a decision by the World Trade Organization (WTO) that the FSC provisions breach WTO rules by providing subsidies to assist U.S. exports, thus giving U.S. companies an unfair advantage in international trade. The European Union initially brought the complaint to the WTO and has indicated that it expects to ask the WTO to rule on the new scheme, suggesting that it may still not be compliant with WTO rules. Regardless of whether the new scheme would ultimately withstand such a challenge, it would remain in effect during the dispute.

This provision is effective for transactions entered into after September 30, 2000. No corporation may elect to be an FSC after that date. Transition rules are included for current FSCs. The estimated fiscal effect is a revenue decrease of $1.25 million in 2001-02 and $1.55 million in 2002-03.

ALTERNATIVES TO BILL

1. Adopt the provisions requested by the Department of Revenue to update state tax references to the federal IRC in effect as of December 31, 2000. Decrease projected corporate income tax revenues by $2,000,000 in 2001-02 and $2,950,000 in 2002-03 to reflect the modifications.

Alternative 1	GPR
2001-03 REVENUE (Change to Bill)	**-** $4,950,000

2. Adopt provisions to update state tax references to the federal IRC in effect as of December 31, 2000, except for provisions relating to: (a) environmental remediation costs; (b) corporate donations of computer technology; and (c) foreign sales corporations. This option would not adopt the new federal provisions that would result in decreased state tax revenues.

Alternative 2	GPR
2001-03 REVENUE (Change to Bill)	$200,000

3. Maintain current law.

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APPENDIX

Federal Law Changes That Have a Minimal or Unknown Fiscal Effect

Individual Income Tax

- Medical Savings Accounts
- Tax Benefits with Respect to Kidnapped Children
- IRAs for Nonworking Spouses

Corporate and Business Taxes

- Renewal Communities
- Empowerment Zones
- Securities Futures Contracts
- Installment Method for Accrual Method Taxpayers