Franchise Tax Board

SUMMARY ANALYSIS OF AMENDED BILL

Author:	Nation	Analyst:	John Pavalasky	Bill Number:	AB 198
Related Bills:	See Prior Analysis	Telephone:	845-4335	Amended Date:	August 18, 2003
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Credit For Qualified Reduced-Emission Vehicles/Depreciation Deduction/No Deduction Allowed For Large Sport Utility Vehicles (SUV)

____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended ________________________.

X AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended ________________________.

X FURTHER AMENDMENTS NECESSARY.

____ DEPARTMENT POSITION CHANGED TO ________________________.

____ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED ________________________. STILL APPLIES.

X OTHER - See comments below.

SUMMARY

This bill would deny the general California business incentives relating to vehicles when a business purchases a large sport utility vehicle (SUV). The revenue from disallowing these incentives would be used to fund a credit for the purchase and use of qualified reduced-emission vehicles in this state.

SUMMARY OF AMENDMENTS

The August 18, 2003, amendments strike-out the previous provisions of the bill and instead would:

1. Add a credit for the purchase and use of qualified reduced-emission vehicles in this state starting in 2004. In addition, the new credit would be allowed to reduce regular tax below tentative minimum tax.
2. Deny depreciation deductions as well as small business expense deductions (including those pertaining to enterprise zones (EZ), local area military base recovery areas (LAMBRA), and targeted tax areas (TTA)) to the owners and lessees of these vehicles with respect to large SUVs, as defined, placed in service in 2004 and later. However, agricultural, timber, and construction businesses would be exempt from the impact of the deduction denials.

Board Position:			Legislative Director	Date
____ S	____ NA	____ NP		
____ SA	____ O	____ NAR	Brian Putler	8/19/2003
____ N	____ OUA	X PENDING		

PURPOSE OF THE BILL

According to the author's office the purpose of the bill is to modify California law to not allow the business tax benefit for purchasing a large SUV over a more fuel-efficient vehicle and create an incentive for purchasing reduced-emission vehicles.

EFFECTIVE/OPERATIVE DATE

This bill, as a tax levy, would be effective immediately. However, this bill provides that the credit would apply to taxable years beginning on or after January 1, 2004, and before January 1, 2008, and a sunset date of December 1, 2008, is provided. The bill provides that the business incentive disallowance would apply to property placed in service on or after January 1, 2004, and before January 1, 2008, and a sunset date of December 1, 2008, is provided.

POSITION

Pending.

FISCAL IMPACT

If the bill is amended to resolve the implementation considerations addressed in this analysis, the department's costs are expected to be minor.

ECONOMIC IMPACT

Revenue Estimate

Based on the discussion below, the following table reflects the estimated impact of this bill:

Revenue Impact of AB198 as Amended August 18, 2003 For Taxable Years Beginning On Or After 1/1/2004 Fiscal Years (In Millions)				
	2003-04	2004-05	2005-06	2006-7
SUV Deductions	+$5	+$20	+$30	+$20
Qualified Vehicle Applied Credits	$0	-$20	-$30	-$25
Revenue Impact	+$5	$0	$0	-$5

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion:

The impact of this bill would depend upon all of the following items.

- The number and costs of large SUVs.
- The amount of reduced depreciation and expense deductions that would have been allowable under current law.
- The amount of tax decreases resulting from the resale of large SUVs at higher cost basis.

- The number of qualified reduced-emission vehicles sold for use in California.
- The amount of the tax credit certificate issued per qualified reduced-emission vehicle.
- The number of taxpayers claiming the reduced-emission vehicle credit.
- The average applied credit against tax liabilities.

For purposes of this analysis, information obtained from a report released by US Public Interest Research Group in 1999 was used. In addition, the following assumptions were made:

(1) Assumed that approximately 50% of large SUVs sold or leased currently are allowed some sort of deduction. Of these vehicles it is estimated that approximately 20% qualify for both operating lease deductions and depreciation deductions, and 10% would be exempt from this bill.
(2) The average annual deduction per vehicle is $5,000.
(3) The average write-off period for these vehicles is three years.
(4) The business use of leased SUVs would decline by 15% annually as a result of this bill.
(5) The average marginal tax rate of 6% was used.

SUV Deductions

To arrive at the annual revenue gain, it was determined from the US Public Interest Research Group's report that approximately 730,000 qualifying vehicles would be sold or leased in the United States in 2004. Of this total it is estimated that 11% would be located in California (84,000).

Assuming 55% of the vehicles would no longer receive an average deduction of $5,000, disallowed deductions would amount to approximately $230 million for vehicles purchased or leased in 2004. Assuming an average marginal tax rate of 6% the first year, revenue gain is estimated to be approximately $14 million (6% x $230 million = $14 million). The fiscal-year estimates above reflect changes in estimated tax and final tax payments. That is, it was assumed that 35% of the $14 million first-year revenue gain would be reflected in increased estimate payments in the 2003-04 fiscal year resulting in the $5 million estimate for that fiscal year. Credits, however, exhibit a different fiscal-year pattern as discussed below.

The above revenue impact for the SUV deduction represents a timing effect, reduced depreciation deductions, and expenses offset in future years by a decrease in the amount of gain realized from the sale of the vehicle due to its unreduced basis under this bill.

Qualified Vehicle Applied Credits

According to the Air Resources Board, it is estimated that the number of qualifying vehicles will exceed the estimated increase in state taxes when divided by the maximum credit allowable per vehicle of $1,000. Therefore, all of the estimated increase in state taxes for any given fiscal year would be allocated to the credit.

The fiscal year cash flow patterns reflect applied credits in the respective years and are based on an analysis of how taxpayers adjust their tax payments to reflect a change in liability resulting from current law. That is, prior fiscal year estimated tax payments are not typically adjusted to take into account the availability of the credit but instead, because of the carryover, the application of the credit is reflected in the succeeding fiscal year. Thus, applied credits reflect not only the credits allocated in 2006-07, but also the carryover of unapplied credits from prior fiscal years.

ANALYSIS

Each of the amendments is discussed separately.

1. Credit For Qualified Reduced-Emission Vehicles

FEDERAL/STATE LAW

Current federal law

A tax credit of 10% of the cost of a qualified electric vehicle is allowed in the year that it is placed in service by the taxpayer. The vehicle must be placed in service after June 30, 1993, and before 2007. The maximum credit is $4,000 per qualified electric vehicle; however, for vehicles placed in service in 2004 through 2006, the credit is reduced 25% each year.

A qualified electric vehicle is defined as one powered primarily by an electric motor drawing current from rechargeable batteries, fuel cells, or other portable sources of electric current. The credit is recaptured in the year in which the vehicle ceases to be a qualified electric vehicle.

Current state law

California has not conformed to this federal credit.

THIS BILL

This bill would, starting in 2004, allow taxpayers to claim a $1,000 tax credit in the taxable year that a qualified reduced-emission vehicle that has been issued a tax credit certificate is purchased and placed in service in California. Any unused credit would be carried forward to reduce tax in the next and succeeding five years. A prorated portion of the credit would be recaptured if the vehicle is sold, disposed of, or not used at least 80% of the time in this state during the purchase year and each of the succeeding two taxable years.

A qualified reduced-emission vehicle is defined as a new Zero Emission Vehicle, Partial Zero Emission Vehicle, or Advanced Technology Partial Zero Emission Vehicle that has been granted a tax credit certificate.

This bill requires the Air Resources Board (ARB) to allocate the tax credit certificates to retail dealers on a first-come, first-served basis. To receive an allocation, the retail dealer must show that the number of tax credit certificates being requested reflects the number of qualified vehicles (without certificates) held as inventory by the dealer. The retail dealer is required to list the vehicle identification number on the tax credit certificate provided to the purchaser and retain a copy in its records.

The maximum amount of credits that the ARB may allocate (in increments of $1,000) each fiscal year is equal to the Franchise Tax Board (FTB) estimate of revenue raised in the fiscal year arising from the disallowance of deductions for large SUVs. The FTB is required to make that estimate and provide its determination to the ARB on October 1, 2003, and each October 1 thereafter. If the amount of the FTB determination is not exactly divisible by $1,000, the number of credits would be rounded up to next full number.

This bill requires that the taxpayer purchasing the qualified vehicle receive the tax credit certificate from the retail dealer. The taxpayer then claims the credit in the taxable year that a qualified reduced-emission vehicle that has been issued a tax credit certificate is purchased and placed in service in California. The taxpayer must retain the tax credit certificate and provide a copy upon request of the FTB.

This bill provides that the credit would apply to taxable years beginning on or after January 1, 2004, and before January 1, 2008, and a sunset date of December 1, 2008, is provided.

<u>IMPLEMENTATION CONSIDERATIONS</u>

This bill requires that a prorated portion of the credit would be recaptured if the vehicle is sold, disposed of, or not used at least 80% in this state during the purchase year and each of the succeeding two taxable years. However, in the case where the qualified vehicle is purchased and placed in service in 2007, the sunset date for the credit of December 1, 2008, would repeal this section (including the recapture provision) before the full three taxable year recapture period. This consideration would be resolved by revising the sunset date of the credit sections to December 1, 2010.

LEGISLATIVE HISTORY

AB 848 (Nation, 2003/04) is identical to this bill and is currently in the Assembly Revenue and Taxation Committee.

AB 1390 (Ridley-Scott, 2003/04) would allow a tax credit for purchases of new fuel-efficient vehicles if the Department of Finance certifies that it finds projected state revenues will exceed projected state expenditures and that bill is currently in the Assembly Revenue and Taxation Committee.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, Oregon,* and *New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws. None of these states allows credits for electric cars or reduced-emission vehicles.

2. Eliminate Deductions For Large SUV

<u>FEDERAL/STATE LAW</u>

Current Federal Law

Under federal law a corporate or noncorporate taxpayer (other than estates, trusts, or certain noncorporate lessors) may elect to treat the cost of qualifying property (called Section 179 property) as a current expense rather than being required to depreciate the property over a number of years. The Jobs And Growth Tax Relief Reconciliation Act (JGTRRA) of 2003 increased the maximum deduction for 2003, 2004, and 2005 from $25,000 to $100,000.

This maximum deduction is reduced, on a dollar for dollar basis, once assets costing more than $400,000 (increased from $200,000 by JGTRRA) have been placed in service by the taxpayer during the taxable year. This reduction is the mechanism used to target the benefit to small businesses.

Federal law also contains rules (called the luxury car limits) that limit the amount of depreciation or Section 179 expensing that can be deducted each year for certain passenger vehicles. These luxury car limits apply to leases of passenger vehicles by requiring an amount to be added to income in each year of the lease (using tables issued by the Internal Revenue Service) based on the fair market value of the vehicle for that year. For purposes of the luxury car limits, a passenger vehicle is any four-wheeled vehicle manufactured primarily for use on public streets, roads, and highways that has an *unloaded* gross vehicle weight (i.e., curb weight fully equipped for service but without passengers or cargo) of 6,000 pounds or less. However, a passenger vehicle includes a truck or van (including a SUV or minivan) if it has a gross vehicle weight (i.e., maximum total weight of a *loaded* vehicle as specified by the manufacturer) of 6,000 pounds or less. Consequently, some large SUVs are not subject to the luxury car limits.

Current State Law

California is conformed, in general, to the federal Section 179 deduction and the luxury car limits for noncorporate taxpayers and S corporations, with the following differences:

- For non-corporate taxpayers, the maximum deduction for 2003 and later years is $25,000.
- This maximum deduction is reduced, on a dollar for dollar basis, once assets costing more than $200,000 have been placed in service by the taxpayer during the taxable year.

For corporations, the maximum expensing deduction is $2,000. Also, the depreciable lives of corporate assets vary by type of asset but, in general, are longer than the depreciation period under federal law.

In addition, California allows a business operating in the following economic development areas, in lieu of the Section 179 deduction, to deduct currently as an expense (rather than depreciate) a larger portion of a depreciable asset (defined by reference to Section 1245(a)(3) of the Internal Revenue Code):

- Enterprise Zones (EZ's),
- Local Agency Military Base Recovery Areas (LAMBRA's), and
- Targeted Tax Area (TTA).

THIS BILL

With respect to large SUVs, as defined, placed in service in 2004 and later, this bill would deny depreciation deductions as well as small business expense deductions (including those pertaining to enterprise zones (EZ), local area military base recovery areas (LAMBRA), and targeted tax areas (TTA)) to the owners of these vehicles.

Thus, if a taxpayer purchases a large SUV, or the taxpayer leases the large SUV under a finance lease (i.e., the taxpayer and not the leasing company is treated as the owner of the vehicle), that taxpayer would be denied depreciation deductions as well as small business expense deductions with respect to that vehicle. In addition, if the taxpayer leases a large SUV under an operating lease (i.e., the leasing company is treated as the owner of the vehicle), the leasing company would be denied depreciation deductions as well as small business expense deductions with respect to any large

SUVs that are leased to others. Under the bill as amended July 14, 2003, a taxpayer with an operating lease would be denied the business expense for the lease payments.

This bill exempts agricultural, timber, and construction businesses from the deduction denials.

This bill would define a large SUV as a four-wheeled vehicle manufactured primarily for use on public streets, roads, and highways if the vehicle meets all of the following requirements:

(1) Is rated between 6,000 and 14,000 pounds gross vehicle weight,
(2) Is designed to seat nine or fewer individuals, and
(3) Is not equipped with an open cargo area with an interior length of 72 or more inches or does not have a covered box with an interior length of 72 or more inches that is separate from the passenger compartment.

LEGISLATIVE HISTORY

AB 848 (Nation, 2003/04) is identical to this bill and is currently in the Assembly Revenue and Taxation Committee.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, Oregon,* and *New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws. Pending *Oregon* and *New York* legislation would deny depreciation deductions and small business expense deductions with respect to large SUVs. None of the other states surveyed currently have similar laws or are proposing similar legislation.

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