

SUMMARY ANALYSIS OF AMENDED BILL

Author: Klehs and Machado Analyst: John Pavalasky Bill Number: AB 115
 Related Bills: _____ Telephone: 845-4335 Amended Date: August 23, 2005, and August 30, 2005
 Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Conformity Act of 2005

- DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as amended June 20, 2005.
- AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.
- _____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENTS CONCERNS stated in the previous analysis of bill as introduced/amended _____.
- _____ FURTHER AMENDMENTS NECESSARY.
- _____ DEPARTMENT POSITION CHANGED TO _____.
- REMAINDER OF PREVIOUS ANALYSES OF BILL AS AMENDED May 2, 2005, May 27, 2005, and June 20, 2005, STILL APPLIES.
- OTHER – See comments below.

SUMMARY

This bill would change California's specified date of conformity to federal income tax law from January 1, 2001, to January 1, 2005, and thereby, in general, conform to the numerous changes made in federal income tax law during that four-year period.

SUMMARY OF AMENDMENTS

The August 23, 2005, amendments removed conformity to the Health Savings Account (HSA) provisions of federal law.

The August 30, 2005, amendments would start full conformity to the federal student loan interest deduction in 2006 instead of 2007 and specifically allow corporations to elect small business expensing in conformity with federal law to the same extent as is allowed under the Personal Income Tax Law (PITL) in lieu of the 20% bonus depreciation allowed under current law.

Also, the August 30, 2005, amendments make technical corrections to resolve issues arising during the department's review of AB 115.

Board Position:

S _____ NA _____ NP
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Legislative Director

Date

Brian Putler

08/31/05

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy. Thus, it would be effective immediately, and unless otherwise specified, it would apply to taxable years beginning on or after January 1, 2005. The provisions of this bill that conform to federal provisions that are subject to the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) termination date would apply to taxable years beginning before January 1, 2011. The bill specifically makes the low sulfur diesel fuel credit and expensing provisions to apply to taxable years beginning on or after July 1, 2005. Also, the bill makes full conformity to the student loan interest rules apply to taxable years beginning on or after January 1, 2006.

POSITION

Support.

At its June 15, 2005, meeting the Franchise Tax Board voted 2 – 0, with the representative from the Department of Finance abstaining, to support AB 115.

The EFFECTIVE /OPERATIVE DATE and ECONOMIC IMPACT portions of the previous analysis of the bill as amended June 20, 2005, have been updated. In addition, an analysis is provided of the provision that would allow corporations to elect small business expensing in lieu of depreciation in conformity with federal law to the same extent as is allowed under the PITL. The POSITION, LEGAL IMPACT, and ARGUMENTS/POLICY CONCERNS have not changed but are restated for convenience. The remainder of the analyses of the bill as amended May 2, 2005, May 27, 2005, and June 20, 2005, still applies.

ANALYSIS OF CORPORATION SMALL BUSINESS EXPENSING PROVISION

FEDERAL/STATE LAW

Current Federal Law

Current federal law under Section 179 provides that, in lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct such costs. The maximum amount a taxpayer may deduct, for taxable years beginning in 2003¹ through 2007², was increased from \$25,000 to \$100,000 of the cost of qualifying property placed in service for the taxable year. In general, qualifying property is defined as depreciable tangible personal property (and certain computer software through 2007) that is purchased for use in the active conduct of a trade or business. The \$100,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000 (\$400,000 for taxable years through 2007). The \$100,000 and \$400,000 amounts are indexed for inflation.

¹ The Jobs Growth Tax Relief Reconciliation Act (JGTRRA) of 2003, Pub. L. No. 108–27, Sec. 202 (2003).

² The American Jobs Creation Act (AJCA) of 2004, Pub. L. No. 108–357, Sec. 201 (2004) extended the provision through 2007.

The amount eligible to be expensed under Section 179 for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).

No general business credit is allowed with respect to any amount for which a deduction is allowed under Section 179. Under current law, an expensing election is made under rules prescribed by the Secretary. Applicable Treasury regulations provide that an expensing election generally is made on the taxpayer's original return for the taxable year to which the election relates. Prior to 2003 (and for taxable years beginning in 2008 and thereafter), an expensing election may be revoked only with consent of the Commissioner. Taxpayers are allowed to revoke expensing elections on amended returns without the consent of the Commissioner with respect to a taxable year beginning after 2002 and before 2008.

Exception for Sport Utility Vehicles (SUV)

The AJCA³ limits the ability of taxpayers to claim deductions under Section 179 for certain vehicles to a maximum of \$25,000. The limitation applies to SUVs rated at 14,000 pounds gross vehicle weight or less. For this purpose, an SUV is defined to exclude any vehicle that:

- Is designed for more than nine individuals in seating rearward of the driver's seat.
- Is equipped with an open cargo area, or a covered box not readily accessible from the passenger compartment, of at least six feet in interior length.
- Has an integral enclosure, fully enclosing the driver compartment and load carrying device, does not have seating rearward of the driver's seat, and has no body section protruding more than 30 inches ahead of the leading edge of the windshield.

Current California Law

Under the PITL, California law is conformed to the federal Section 179 deduction as it read on January 1, 2001, prior to the enactment of JGTRRA or the AJCA. Thus, a non-corporate taxpayer with a sufficiently small amount of annual investment may elect to deduct up to \$25,000 of the cost of qualifying property placed in service for the taxable year. The \$25,000 amount is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000. In general, qualifying property is defined as depreciable tangible personal property that is purchased for use in the active conduct of a trade or business. The amount eligible to be expensed for a taxable year may not exceed the taxable income for a taxable year that is derived from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations).

Under current California law, S corporations and their shareholders are allowed to take the Section 179 deduction as provided under the PITL. For taxable years beginning on or after January 1, 2002,

³ The American Jobs Creation Act (AJCA) of 2004, Pub. L. No. 108-357, Sec. 910 (2004)

an S corporation may elect to expense up to \$25,000 in the computation of the S corporation's measured tax (presently the S corporation tax rate for non-financial corporations is 1.5%). Under the Corporation Tax Law (CTL), California does not conform to the federal law Section 179 expensing provisions. However, the CTL permits an "additional first-year depreciation" deduction of 20% of the cost of qualifying property (up to a maximum cost of \$10,000 per year). Thus, a maximum expense deduction of \$2,000 per year is allowed. Property qualifying for the "additional first-year depreciation" is similar to property qualifying under IRC Section 179.

THIS BILL

This bill would specifically not conform the PITL to the changes made to the federal law Section 179 expensing provisions by JGTRRA and the AJCA. Thus, under the bill a non-corporate taxpayer with a sufficiently small amount of annual investment would continue to be able to elect to deduct up to \$25,000 of the cost of qualifying property placed in service for the taxable year. The \$25,000 amount would be reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000.

The August 30, 2005, amendments would conform to the federal Section 179 expensing provisions under the CTL to the same extent as the bill proposes under the PITL. That is, under the bill a corporate taxpayer with a sufficiently small amount of annual investment would be able to elect to deduct up to \$25,000 of the cost of qualifying property placed in service for the taxable year in lieu of the current law "additional first-year depreciation" of up to \$2,000. The \$25,000 amount would be reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds \$200,000.

SUMMARY OF ECONOMIC IMPACT

Revenue Estimate AB 115 as Amended August 30, 2005 – Changes to Table in Bold

Conformity to Provisions Changed in Federal Law Before 2004
 Applies to Taxable Years Beginning On Or After January 1, 2005, Except as Noted

Federal Act Section	Description	(In millions)		
		2005-06	2006-07	2007-08
	IRC Section 179 – Corporation small business expense deductions	-\$10	-\$12	-\$9
412	PL 107-16 (Economic Growth and Tax Relief Act of 2001) Student Loan Interest	-\$8	-\$15	-\$15
404	JCWAA of 2002 (P.L. 107-147) - Expansion of the exclusion from income for qualified foster care payments.	-\$4	-\$3	-\$3

Conformity to the WFTRA of 2004 (PL 108-311)
 And The AJCA (PL 108-357)
 Applies to Taxable Years Beginning On Or After January 1, 2005

Federal	Provisions	(In millions)
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Act Section		2005-06	2006-07	2007-08
WFTRA 201-208	Uniform definition of child, etc.	-\$10	-\$7	-\$7
320	Disclosures relating to terrorist activities	-	-	-
322	Extension of expiring provisions- Availability of medical savings accounts	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
401-408	Technical amendments	-	-	-
AJCA 231	Members of family treated as 1 shareholder	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
232	Increase in number of eligible shareholders to 100	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
233	Expansion of bank S corporation eligible shareholders to include IRAs	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
234	Disregard of unexercised powers of appointment in determining potential current beneficiaries of ESBT	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
235	Transfer of suspended losses incident to divorce, etc.	b/	b/	b/
236	Use of passive activity loss and at-risk amounts by qualified subchapter S trust income beneficiaries	b/	b/	b/
237	Exclusion of investment securities income from passive income test for bank S corporations.	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
238	Relief from inadvertently invalid qualified subchapter S subsidiary elections and terminations	b/	b/	b/
239	Information returns for qualified subchapter S subsidiaries.	b/	b/	b/
240	Repayment of loans for qualifying employer securities	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
243	Improvements related to real estate investment trusts	b/	b/	b/
247	Modification of unrelated business income limitation on investment in certain small business investment companies	b/	b/	b/
311	Special rules for livestock sold on account of weather-related conditions	-\$1	-\$1	f/

312	Payment of dividends on stock of cooperatives without reducing patronage dividends.	b/	b/	b/
315	Capital gain treatment under Section 631(b) to apply to outright sales by landowners.	b/	b/	b/
318	Certain expenses of rural letter carriers	b/	b/	b/
320	Exclusion for payments to individuals under National Health Service Corps loan repayment program and certain State loan repayment programs	b/	b/	b/
321	Modification of safe harbor rules for timber REITs.	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]
322	Expensing of certain reforestation expenditures	-\$1	-\$1	f/
331	Net income from publicly traded partnerships treated as qualifying income of regulated investment companies	b/	b/	b/
335	Charitable contribution deduction for certain expenses incurred in support of Native Alaskan subsistence whaling	b/	b/	b/
338	Expensing of capital costs incurred in complying with Environmental Protection Agency sulfur regulations. Revenue same as AB 810 (Parra) as introduced. [2]	d/	b/	a/
339	Credit for production of low sulfur diesel fuel. Revenue same as AB 810 (Parra) as introduced. [2]	d/	-\$1	-\$1
702	Exclusion of gain or loss on sale or exchange of certain brownfield sites from unrelated business taxable income	b/	b/	b/
703	Civil rights tax relief	-\$1	-\$1	-\$1
704	Modification of class life for certain track facilities	-\$1	-\$1	-\$1
706	Certain Alaska natural gas pipeline property treated as 7-year property	\$0	\$0	\$0
708	Method of accounting for naval shipbuilders	-\$4	-\$7	-\$6
709	Modification of minimum cost requirement for transfer of excess pension assets.	Baseline loss [1]	Baseline loss [1]	Baseline loss [1]

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811-820	Provisions relating to reportable transactions and tax shelters	Baseline gain [1]	Baseline gain [1]	Baseline gain [1]
831	Treatment of stripped interests in bond and preferred stock funds, etc.	e/	e/	c/
833	Disallowance of certain partnership loss transfers	e/	e/	e/
		+Baseline gain [1]	+Baseline gain [1]	+Baseline gain [1]
834	No reduction of basis under Section 734 in stock held by partnership in corporate partner	e/	e/	e/
835	Repeal of special rules for FASITS	a/	a/	a/
836	Limitation on transfer or importation of built-in losses	e/	\$1	\$1
		+Baseline gain [1]	+Baseline gain [1]	+Baseline gain [1]
838	Denial of deduction for interest on underpayments attributable to nondisclosed reportable transactions	a/	a/	a/
839	Clarification of rules for payment of estimated tax for certain deemed asset sales.	\$2	\$1	-
840	Recognition of gain from the sale of a principal residence acquired in a like-kind exchange within 5 years of sale	\$1	\$1	\$1
841	Prevention of mismatching of interest and original issue discount deductions and income inclusions in transactions with related foreign persons	\$2	\$3	\$1
842	Deposits made to suspend running of interest on potential underpayments	-\$2	d/	d/
843	Partial payment of tax liability in installment agreements.	\$1	c/	f/
845	Expanded disallowance of deduction for interest on convertible debt	\$3	\$3	\$3
847-849	Reform of tax treatment of certain leasing arrangements	\$3	\$4	\$5
		+Baseline gain [1]	+Baseline gain [1]	+Baseline gain [1]
882	Treatment of charitable contributions of patents and similar property	e/	e/	e/
883	Increased reporting for noncash charitable contributions	a/	a/	a/

884	Donations of motor vehicles, boats, and airplanes	\$7	\$8	\$8
885	Treatment of nonqualified deferred compensation plans	Baseline gain [1]	Baseline gain [1]	Baseline gain [1]
886	Extension of amortization of intangibles to sports franchises	\$3	\$3	\$1
888	Modification of straddle rules	\$1	\$1	\$1
896	Recognition of cancellation of indebtedness income realized on satisfaction of debt with partnership interest	\$2	\$1	\$1
897	Denial of installment sale treatment for all readily tradable debt.	\$2	\$1	e/
898	Modification of treatment of transfers to creditors in divisive reorganizations	e/	e/	e/
899	Clarification of definition of nonqualified preferred stock	c/	c/	c/
902	Consistent amortization of periods for intangibles	\$5	\$15	\$15
903	Freeze of provisions regarding suspension of interest where Secretary fails to contact taxpayer [2]	\$2	\$2	\$1
905	Treatment of sale of stock acquired pursuant to exercise of stock options to comply with conflict-of-interest requirements	Baseline gain [1]	Baseline gain [1]	Baseline gain [1]
907	Limitation of employer deduction for certain entertainment expenses	\$6	\$6	\$7
	TOTAL (excluding baseline estimates and footnoted estimates)	-\$2	\$1	\$2

[1] For baseline estimates see revenue impact discussion in the individual sections.
[2] Estimates based on State data. Otherwise, all estimates are based on Federal pro-rations.
a/ Insignificant gains of less than \$150,000
b/ Insignificant losses of less than \$150,000
c/ Negligible gains of less than \$250,000
d/ Negligible losses of less than \$250,000
e/ Minor gains of less than \$500,000
f/ Minor losses of less than \$500,000

LEGAL IMPACT

This bill contains provisions that would target certain provisions relating to low-sulfur diesel fuel to California.

The U.S. Court of Appeals for the 6th Circuit ruled in *Cuno v. DaimlerChrysler, Inc.* (2004) 386 F. 3d 738 that Ohio's Investment Tax Credit is unconstitutional because it gives improper preferential treatment to companies to locate or expand in Ohio rather than in other states and, therefore, violates the Commerce Clause of the U.S. Constitution. Ohio is seeking review by the U.S. Supreme Court. Although the outcome of this decision and its effects on the income tax credits of other states, including California, is unknown, targeted tax incentives that are conditioned on activities in California may be subject to constitutional challenge.

Recently introduced federal legislation titled the "Economic Development Act of 2005," S. 1066 and H. R. 2471, would authorize state tax incentives for economic development purposes that may otherwise be subject to constitutional challenge as discriminatory.

ARGUMENTS/POLICY CONCERNS

Conforming to federal tax law is generally desirable because it is less confusing for the taxpayer. With conformity, the taxpayer is required to know only one set of rules. Additionally, the taxpayer needs to maintain only one set of books. Conformity also eases the burden of the Franchise Tax Board to administer the law by utilizing many federal forms, instructions, and regulations. In addition, whenever possible the department uses federal information to verify that taxpayers pay the proper amount of tax. This eliminates the need for the taxpayer to submit the same information to both the IRS and the department.

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