Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Houston	Analyst:	Nicole Kwon	Bill Number:	AB 2488
Related Bills:	See Legislative History	Telephone:	845-7800	Introduced Date:	February 21, 2008
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Depreciation Deduction/Qualified Greenhouse Gas Emission Reduction Capital Expenditures & Qualified Renewable Energy Capital Investments/Taxpayers May Elect To Take Entire Amount Of Expenditures And Investments In 3 Years

SUMMARY

This bill would provide an alternative depreciation deduction to taxpayers for the cost of acquiring machines or equipment that reduce greenhouse gas emissions or produce, generate, or store renewable energy from specified sources.

PURPOSE OF THE BILL

According to the author's office, this bill would encourage the acquisition of property that would measurably reduce greenhouse gas emissions.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2008, and before January 1, 2013.

POSITION

Pending.

SUMMARY OF SUGGESTED AMENDMENT

Technical amendment is necessary and is provided.

ANALYSIS

FEDERAL/STATE LAW

Depreciation

Existing state and federal laws generally allow a depreciation deduction for the obsolescence or wear and tear of property used in the production of income or property used in a trade or business. The amount of this deduction is determined, in part, by the cost (or basis) of the property. In addition, the property must have a limited, useful life of more than one year. The depreciation deduction is generally allowed over a period approximating the property's economic life rather than deducted in the year purchased or acquired.

Board Position:			Department Director	Date
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Existing federal law uses the Modified Accelerated Cost Recovery System (MACRS) for property placed in service after 1986. Under MACRS, the depreciation deduction is computed using the "applicable depreciation method," the "applicable recovery period," and the "applicable convention." MACRS provides three applicable depreciation methods: (1) 200% declining balance, (2) 150% declining balance, and (3) straight-line. The applicable recovery period ranges from 3 to 50 years, depending on the type of property. The applicable convention requires that property placed in service be treated as placed in service on the mid-point of either the taxable year (half-year convention), the month (mid-month convention), or the quarter (mid-quarter convention).

Existing federal law provides an alternative depreciation system (ADS), which generally provides longer recovery periods than the standard MACRS recovery periods and requires use of the straight-line depreciation method. Six types of property are subject to ADS: (1) tangible property used predominantly outside the United States, (2) tax-exempt use property, (3) tax-exempt bond financed property, (4) imported property covered by an Executive Order, (5) property for which the taxpayer has made an election, and (6) any plants produced in a farming business for which the taxpayer has made an election to exempt the crop from the uniform capitalization rules.

In addition, as an incentive for businesses to invest in property, occasionally an accelerated depreciation deduction is allowed. That is, a deduction is allowed at a faster rate than the decline in the property's economic value would warrant.

Federal law allows certain taxpayers to expense the Internal Revenue Code (IRC) section 179 property, in lieu of depreciation. For taxable years beginning in 2008, the maximum amount that a taxpayer may expense is $128,000 of the cost of qualifying property placed in services for the taxable year. The $128,000 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 $510,000. The "Economic Stimulus Act of 2008," as passed by the House of Representatives and the Senate on February 7, 2008, provides temporary increases in limitations on expensing of certain depreciable business assets from $128,000 and $510,000 to $250,000 and $800,000, respectively. The $250,000 and $800,000 amounts are not indexed for inflation. This provision is effective for taxable years beginning after December 31, 2007.

California conforms to the general federal rules for expensing IRC section 179 property with the following exceptions.[1]

- California law only allows a maximum deduction of $25,000.
- The phaseout dollar limits set by IRC section 179 (b)(2) do not apply; instead the California $25,000 maximum expensing amount is reduced dollar-for-dollar by the amount of qualified expensing-eligible property placed in service during the tax year in excess of $200,000.
- California's threshold is not adjusted for inflation.
- The California election is revocable with respect to any taxable year starting after 2002 and before 2008.
- California law does not extend to expensing computer software.

[1] Revenue & Taxation Code section 17255

Under the existing Personal Income Tax Law (PITL), California generally conforms to the federal MACRS and ADS. Existing state Corporation Tax Law (CTL) does not conform to the federal MACRS or ADS. Instead, property must be depreciated over its estimated useful life, which is the period over which the asset may reasonably be expected to be useful in the trade or business. Taxpayers may elect to use the useful life specified under the federal Class Life Asset Depreciation Range System (ADR). ADR groups assets into more than 100 classes and assigns an asset guideline period, or useful life, to each class. For purposes of grapevines (in the agricultural class), the ADR asset guideline period is ten years.

Current California law uses the following depreciation methods for tangible property:

1) Straight-line method,
2) 200% declining balance method,
3) Sum of the years-digit method, and
4) Any other consistent method productive of an annual allowance that, when added to all allowances for the period commencing with the taxpayer's use of the property, exceed the total of those allowances that would have been used had those allowances been computed under the 200% declining balance method.

Methods under (2), (3), and (4) above may be used for tangible property with a useful life of three or more years.

THIS BILL

This bill would allow taxpayers to elect under PITL and CTL an alternative depreciation deduction for "qualified capital expenditures" and "qualified capital investments."

This bill would define the following terms:

- "Qualified capital expenditures" are engines, boilers, generators, or other tangible personal property that measurably reduce greenhouse gas emissions from a qualified facility.
- "Qualified capital investments" means equipment used to produce, generate, or store renewable energy from biomass, solar, wind, and hydrogen sources.
- "Qualified facility" means both of the following:
  - An existing facility of the taxpayer, and
  - The expansion of an existing facility of the taxpayer, in the same location as, or adjacent to, an existing facility of the taxpayer.

This bill would allow taxpayers to elect to take the deduction for the entire amount of qualified capital expenditures and qualified capital investments over three years, starting with the year the expenditures and investments are paid or incurred and the two subsequent years, using the straight-line method of depreciation.

This bill does not specify if the qualified property must be used in California.

This bill does not specify if the qualified facility must be located in California.

This bill would provide a repeal date of December 1, 2013.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

This bill would allow a taxpayer to elect the straight-line method of depreciation over a three-year period in place of any other allowable depreciation method. The bill is silent about whether the election is irrevocable. As a result, the department would treat the election as though it were revocable. This would allow a taxpayer to be inconsistent[2] in the accounting methods used and allow the taxpayer to switch the method of depreciation, such as from the straight-line method to other depreciation methods currently allowed under the state law, for advantageous retroactive tax planning at any time during the three-year period. If this is not the author's intention, the bill should be amended to specify that the election, once made, would be irrevocable.

This bill would disallow the alternative depreciation deduction provided in the bill unless the taxpayer is in compliance with any requirements relating to statewide greenhouse gas emission levels imposed pursuant to the Health and Safety Code. The Franchise Tax Board staff lacks expertise in greenhouse gas emission requirements. The author's office may wish to consider having a qualified third-party, such as the California Environmental Protection Agency, certify that the taxpayer is in compliance with the statewide greenhouse gas emission requirements.

Because this bill would not specify whether the "qualified facility" must be located within California or whether the qualified property must be "placed in service" within California to be eligible for the election, a taxpayer may be able to claim the deduction for property used in an out-of-state facility.

This bill is silent about what "measurably reduces greenhouse gas emissions from a qualified facility" means. The author's office may want to clarify how this reduction can be measured for the department to administer the provisions of this bill.

This bill is silent about whether the property must be purchased "new" or whether used property would also qualify. Because the deduction is not limited to new property, the original use of which commences with the taxpayer, taxpayers could sell the property among affiliates and, absent any kind of recapture provision, continually generate new deduction. The author may wish to add a recapture mechanism that requires the taxpayer to use the qualified property for a minimum period in order to qualify for the credit.

TECHNICAL CONSIDERATIONS

This bill uses the term "other tangible personal property" as a part of the definition of "qualified capital expenditures" and "equipment" in the definition of "qualified capital investments". It is unclear if the author intends to apply the deduction to properties described in IRC section 1245(a)(3) (B). The author may wish to distinguish between "tangible personal property" and" other tangible property." Tangible property is a broader term that includes certain types of real property and personal property that become affixed to a building or structural components.

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[2] Consistency is a principle of Generally Accepted Accounting Principles.

LEGISLATIVE HISTORY

AB 6 (Houston, 2007/2008) was identical to this bill in that AB 6 would have provided an alternative depreciation deduction to taxpayers for the cost of acquiring machines or equipments that can reduce greenhouse gas emissions. AB 6 failed to pass out of the first house by January 31, 2008, the second year of the session.

AB 1651 (Arambula, 2007/2008) would have enacted a tax credit for equipment used to reduce greenhouse gas emissions. The bill failed to pass out of the first house by January 31, 2008, the second year of the session.

PROGRAM BACKGROUND

According to the scientific community, climate change poses a serious threat to California's economic well-being, public health, and environment if aggressive actions to reduce greenhouse gas emissions are not taken soon. In response to the warning from the scientific community, AB 32 (Nunez, 2005/2006), the Global Warming Act of 2006, codifies the state's goal of reducing global warming emissions by 25% by 2020.

OTHER STATES' INFORMATION

Florida, Illinois, Massachusetts, Michigan, Minnesota, and *New York* laws do not provide a deduction comparable to the deduction allowed by this bill. The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

FISCAL IMPACT

The department's costs to administer this bill cannot be determined until implementation concerns have been resolved but are anticipated to be minor.

ECONOMIC IMPACT

<u>Revenue Estimate</u>

Based on data and assumptions discussed below, this bill would result in the following revenue losses.

Estimated Revenue Impact of AB 2488 as Introduced 2/21/2008 Effective for Taxable Years BOA 1/1/2008 ($ in Millions)		
2008-09	2009-10	2010-11
-$17	-$75	-$165

Estimates reflect qualified capital expenditures and investments incurred worldwide by taxpayers with franchise or income tax nexus in California. Enactment is assumed after June 30, 2008. This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

This bill proposes an alternative method of depreciation that allows an accelerated deduction for specified equipment and investments. The revenue impact of this bill would be determined by the difference in the amount of depreciation deductions proposed under this bill and otherwise available under present law.

The survey of Annual Capital Expenditures 2005 indicates businesses nationwide spent $744.4 billion for equipment. The amount spent for qualified capital equipment and investments as defined in the bill is unknown. Using income and expenditure data from industries most likely to use the property in this bill, it is assumed 5% of the $744.4 billion would be spent on such equipment and investments, or approximately $37.2 billion, at the 2005 level ($744.4 billion x 5%). The $37.2 billion is grown by the forecast in corporate profits as projected in the Governor's Budget to derive a projection at the 2008 level of $43.8 billion. For purposes of an estimate for this bill, it is assumed that 20% of the $43.8 billion is incurred by individuals, or approximately $8.8 billion ($43.8 billion x 20%), and 80% by other business entities, or approximately $35 billion ($43.8 billion x 80%).

With respect to the $8.8 billion projected as spent by individuals, it is assumed California personal income tax (PIT) taxpayers would incur 12.5%, or approximately $1.1 billion ($8.8 billion x 12.5%) in qualified capital equipment and investments specified in this bill. Under present law depreciation provisions, the estimated useful life of qualified capital expenditures and investments ranges from five to ten years. Under this bill, the useful life would be three years. As proposed in this bill, the depreciation deduction would be approximately $365 million ($1.1 billion divided by 3 years).

Assuming an average useful life of 7.5 years under present law, the depreciation deduction is approximately $146 million ($1.1 billion divided by 7.5 years). The difference between the proposed depreciation deduction and the present law depreciation deduction is the incremental deduction benefit under this bill. For PIT taxpayers, this benefit is projected at $219 million for 2008 ($365 million - $146 million).

Applying an average marginal tax rate of 8% results in a potential revenue loss of approximately $17.5 million ($219 million x 8%). Also applied is a rate at which taxpayers are anticipated to elect the alternative depreciation method under this bill. The rate at which this election is made by a taxpayer is estimated to be 60% in 2008 and grow to 95% by 2011. For 2008, applying the 60% rate results in a revenue loss of $10.5 million for PIT taxpayers ($17.5 million x 60%).

With respect to the $35 billion incurred by other business entities, it is assumed that 75% of these expenditures, or approximately $26.3 billion ($35 billion x 75%), are incurred by entities having franchise or income tax nexus in California. As currently drafted, this bill does not require qualified capital equipment be installed at a qualified facility in California or investments for renewable energy be made in California. Therefore, estimates reflect qualified capital expenditures and qualified capital investments incurred worldwide by taxpayers with franchise or income tax nexus in California. As calculated above for PIT taxpayers, a similar calculation is performed to derive the incremental deduction benefit under this bill for taxpayers subject to the CTL. Assuming an average useful life of 7.5 years under present law, the depreciation deduction is approximately $3.5 billion ($26.3 billion ÷ 7.5 years).

As proposed in this bill, the depreciation deduction would be approximately $8.8 billion ($26.3 billion ÷ 3 years). The difference between the present law depreciation deduction and the proposed depreciation deduction is the incremental deduction benefit under this bill. The incremental deduction for corporation taxpayers is projected at $5.3 billion for 2008 ($3.5 billion - $8.8. billion). Applying an average apportionment factor of 10% and a tax rate of 8% results in an additional potential revenue loss of approximately $42 million at the 2008 level ($5.3 billion x 10% x 8%). Also applied is a rate at which taxpayers are anticipated to elect the alternative depreciation method. The rate ranges from 60% of taxpayers in 2008 to 95% by 2011. For 2008, applying a rate of 60% results in a revenue loss of $25.2 million for CTL taxpayers ($42 million x 60%).

For this bill, revenue losses total $35.7 million for the 2008 taxable year ($10.5 million for PIT taxpayers + $25.2 million for CTL taxpayers). Initially, revenue losses increase each additional year as the result of adding another group of electing taxpayers. Beginning with the fourth taxable year, losses begin declining somewhat because, for each additional group of depreciable assets added, a prior group is fully depreciated under this bill. Once a group of assets is fully depreciated under this bill, there are offsetting adjustments for depreciation otherwise deductible under present law. Taxable year estimates have been converted to the fiscal year estimates in the table above.

POLICY CONSIDERATIONS

This bill would increase differences between federal and California income tax law, thereby increasing the complexity of California income tax return preparation.

This bill allows the deduction in the taxable year in which the equipment is purchased, which may be earlier than the taxable year in which the equipment is actually placed in service (i.e., used) in California. Most deduction involving the acquisition and subsequent use of an item of property allow the deduction to be claimed in the taxable year in which the property is placed in service for depreciation purposes. It is possible that a taxpayer could purchase the equipment, claim the deduction, and resell the equipment to a third party that may also claim the deduction. If this bill were to require that the equipment be placed in service in California, with an appropriate recapture provision to ensure continued operation in California for a specified (recapture) period, this potential problem would be avoided.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 2488
As Proposed To Be Amended

AMENDMENT 1

On page 2, lines 3 and 33, delete "in three years" and insert "over a three-year period".