Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Gaines	Analyst:	Scott McFarlane	Bill Number:	AB 2491
Related Bills:	None	Telephone:	845-6075	Amended Date:	April 3, 2008
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Depreciation Deduction Conformity

SUMMARY

This bill would generally conform California franchise and income tax depreciation rules to federal depreciation rules.

SUMMARY OF AMENDMENTS

The bill as introduced on February 21, 2008, was a spot bill. The April 3, 2008, amendments added the depreciation conformity provisions.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to create an incentive for businesses to invest in new equipment, create jobs, and stimulate economic growth.

EFFECTIVE/OPERATIVE DATE

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

POSITION

Pending.

ANALYSIS

In general, individuals and business entities are not allowed to claim the entire cost of a capital asset (any asset with a useful life of more than one year) as an expense in the year acquired. Instead, individuals and business entities must generally recover the cost of the asset over some period, usually an approximation of the asset's useful life. "Depreciation" is the term generally used to describe any method of recovering (commonly referred to as "expensing") the cost of an asset, across its useful life, roughly corresponding to normal wear and tear.

Board Position:			Department Director	Date
_______ S	_______ NA	_______ NP		
_______ SA	_______ O	_______ NAR	Selvi Stanislaus	5/2/08
_______ N	_______ OUA	___X___ PENDING		

FEDERAL/STATE LAW

FEDERAL LAW

Prior to 1981, federal tax depreciation somewhat mirrored financial accounting depreciation. The cost of an asset was recovered over the estimated useful life of the asset, using either a constant charge (straight-line) or an accelerated method.

Accelerated Cost Recovery System (ACRS)

ACRS was enacted as part of a 1981 federal stimulus act, and it accelerated the rate that depreciable assets could be recovered.

Modified Accelerated Cost Recovery System (MACRS)

MACRS replaced ACRS with the passing of the Tax Reform Act of 1986 and is the current cost-recovery system allowed by federal law. MACRS allows a somewhat lesser accelerated rate of recovery than ACRS.

Bonus Depreciation

For certain types of property, federal law allows additional "bonus depreciation." The amount of "bonus depreciation" that may be claimed as an expense in the year an asset is placed in service is generally 30% - 50% of the asset's cost.

Small Business Expensing

In lieu of depreciation, a taxpayer with a sufficiently small amount of annual investment may elect to deduct (or "expense") such costs. Prior to 2003, a qualified taxpayer could elect to deduct up to $25,000 of the cost of qualifying property placed in service for the taxable year. The $25,000 amount was reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeded $200,000.

From 2003 through 2009, the expense and cost limitations were temporarily increased. During this period, the maximum amount a taxpayer may expense is $100,000 of the cost of qualifying property placed in service for the taxable year.[1] 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 $400,000. The $100,000 and $400,000 amounts are indexed for inflation for taxable years beginning after 2003 and before 2010.

For taxable years beginning in 2010 and thereafter, the expense and cost limitations revert back to what they were prior to 2003.

[1] Additional IRC section 179 incentives are provided with respect to qualified property meeting applicable requirements that is used by a business in an empowerment zone (IRC section 1397A), a renewal community (IRC section 1400J), or the Gulf Opportunity Zone (IRC section 1400N(e)).

CALIFORNIA LAW

In General

ACRS

California never conformed to the federal ACRS depreciation rules in either personal income tax or corporate tax law.

MACRS

California conforms with modifications to MACRS for personal income taxpayers and S corporations, but has never conformed to MACRS for corporate taxpayers.

Bonus Depreciation

California never conformed to the federal bonus depreciation rules in either personal income tax or corporate tax law.

Small Business Expensing

California conforms with significant modifications to the small business expensing rules for both personal income taxpayers and corporations.

Specific California Depreciation Rules

Personal Income Tax

MACRS

California generally conforms to MACRS as in effect on January 1, 2005; however, there are several differences between California and federal law, including:

- California does not conform to the federal recovery period for depreciation of certain leasehold improvements and restaurant property;
- California does not conform to the federal rules that allow geological and geophysical costs incurred in connection with oil and gas exploration in the United States to be recovered over two years (seven years for major integrated oil companies);
- California does not conform to the federal accelerated recovery period for qualified Indian reservation property; and
- California allows a faster recovery period for grapevines replaced due to phylolloxera infestation or Pierce’s disease.

Small Business Expensing

California law conforms with modifications to the federal small business expensing provisions as in effect January 1, 2005. Currently a 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.

<u>S Corporations</u>

MACRS

S corporations are allowed to use MACRS, with the same modifications that apply to personal income taxpayers.

Small Business Expensing

California law conforms with modifications to the federal small business expensing provisions. S corporations may elect to expense up to $25,000 in the computation of the S corporation's measured tax (the S corporation tax rate is 1.5% for non-financial corporations and 3.5% for financial corporations).

<u>C Corporations</u>

MACRS

California generally does not allow use of MACRS for corporate taxpayers. Instead, California uses a depreciation system generally known as the Asset Depreciation Range (ADR) system, which is similar to that used in federal law for pre-1981 assets. The ADR system generally requires the use of longer useful lives and fewer accelerated recovery methods than would be allowed under federal MACRS rules.

Small Business Expensing

For taxable years beginning on or after January 1, 2005, corporate tax law conforms to the federal small business expensing provisions as in effect January 1, 2005, with the same modifications that apply to personal income taxpayers.

<u>THIS BILL</u>

This bill would allow California personal income and corporate taxpayers to use the following depreciation rules:

- The same MACRS recovery periods that are allowed for federal purposes;
- The same small business expensing elections that are allowed for federal purposes; and
- The same bonus depreciation amounts that are allowed for federal purposes.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida conforms to the IRC as amended on January 1, 2007. *Florida* does not impose a personal income tax. For corporations, Florida conforms to the federal depreciation rules that were in effect as of January 1, 2007.

Illinois automatically conforms each taxable year to the IRC, and generally conforms to the federal depreciation rules except that bonus depreciation is not allowed.

Massachusetts conforms to the IRC as of January 1, 2005, and generally conforms to the federal depreciation rules except that bonus depreciation is not allowed.

Michigan automatically conforms each taxable year to the IRC, and the depreciation rules are the same as the federal rules.

Minnesota conforms to the IRC as amended through May 18, 2006, and generally conforms to the federal depreciation rules except that bonus depreciation is not allowed.

New York automatically conforms each taxable year to the IRC, and the depreciation rules are generally the same as the federal rules, with modifications to bonus depreciation.

FISCAL IMPACT

The bill would not significantly impact the department's costs.

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 be effective for taxable years beginning on or after January 1, 2008. Changes to depreciation rules generally specify application to property placed in service on or after a specific date. Without a specific placed-in-service date, taxpayers may mistakenly believe that property placed in service prior to January 1, 2008, may be depreciated under the new rules (because those rules would become effective on January 1, 2008).

This bill would eliminate current California rules that allow faster recovery periods for certain types of property.

For certain types of property, personal income taxpayers and corporate taxpayers would have different recovery periods for the same type of property.

ECONOMIC IMPACT

Revenue Estimate

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

Estimated Revenue Impact of AB 2491 Effective for Tax Years BOA 1/1/2008 Enacted After 6/30/2008 ($ in Millions)			
2008 - 09	2009 - 10	2010 - 11	2011 - 12
-$1,650	-$1,100	-$600	-$500

Revenue Discussion

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

The revenue impact of this bill was estimated as the combined impact of:

(1) Fully conforming to MACRS;
(2) The expanded small business expensing allowed by the Jobs and Growth Tax Relief Reconstruction Act of 2003 (JGTRRA of 2003); and
(3) The expanded small business expensing and bonus depreciation deductions allowed by the Economic Stimulus Act of 2008 (ESA of 2008).

The revenue estimate is based on the assumption that the new depreciation rules would apply to property placed in service on or after January 1, 2008, and the current depreciation rules would continue to apply to property placed in service before January 1, 2008.

The revenue impact of conforming to MACRS is estimated based on simulations of depreciation deductions under current California law. These simulations are based on depreciation data by industry and asset type, derived from federal and California tax returns. Conforming to MACRS is estimated to result in a revenue loss of $447 million for the 2008 taxable year.

Estimates of the impact of the expanded small business expensing allowed by the JGTRRA of 2003 and the ESA of 2008, and the bonus depreciation deductions allowed by the ESA of 2008 are based on prorations of federal projections for those Acts, calculated as follows:

- Federal projections for the small business expensing allowed by the JGTRRA of 2003 are extrapolated to 2008 based on California Department of Finance actual and projected corporate profits.
- These federal projections are then added to those for the ESA of 2008 to arrive at the estimated combined impact of the JGTRRA of 2003 and the ESA of 2008 at the federal level.

- The federal projections are then adjusted down using a proration factor of 3.7%. This factor takes into account California's share of individual taxpayers' adjusted gross income and the difference in federal and California tax rates. Conforming to the expanded small business expense and bonus depreciation deductions is estimated to result in a revenue loss of $1,906 million for the 2008 taxable year.

The estimated revenue loss attributed to MACRS is reduced by 45% to reflect that the expanded small business expense and bonus depreciation deductions would reduce the basis of depreciable assets for purposes of MACRS. Thus, the net revenue loss of conforming to MACRS is $246 million (55% x $447 million).

The total revenue loss from this bill would be $2,152 million ($246 + $1,906) for the 2008 taxable year.

The above taxable year estimates are converted to cash flow fiscal year estimates as shown in the table. For example, the 2008-09 revenue loss of $1,650 million includes a loss of $1,200 million from the 2008 tax year, plus a loss of $450 million from the 2009 tax year due to reduced estimated and final tax payments.

LEGISLATIVE STAFF CONTACT

Legislative Analyst
Scott McFarlane
(916) 845-6075
scott.mcfarlane@ftb.ca.gov

Revenue Manager
Rebecca Schlussler
(916) 845-5986
rebecca.schlussler@ftb.ca.gov

Legislative Director
Brian Putler
(916) 845-6333
brian.putler@ftb.ca.gov