Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Dutton	Analyst:	Jahna Alvarado	Bill Number:	SB 357
Related Bills:	See Legislative History	Telephone:	845-5683	Introduced Date:	February 15, 2011
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Depreciation Deduction Refundable Credit/State Agency Regulations/Prohibit Promulgating New Regulation That Renders Tangible Property Obsolete Unless Appropriation Has Been Made For Tax Credit

SUMMARY

This bill would create a refundable income or franchise tax credit for tangible property rendered obsolete by operation of a new state regulation.

RECOMMENDATION AND SUPPORTING ARGUMENTS

No position.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to increase investment in California by providing businesses with the necessary certainty that recently purchased equipment would not be made obsolete by new regulations before the end of the equipment's useful life.

EFFECTIVE/OPERATIVE DATE

This bill would become effective January 1, 2012, and would apply to taxable years beginning on or after that date.

ANALYSIS

<u>FEDERAL/STATE LAW</u>

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. Depreciable property includes equipment, machinery, vehicles, and buildings, but excludes land. Significant improvements to property are added to the basis of the property and are depreciated over the property's remaining useful life.

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Obsolescence may render an asset economically useless to a taxpayer regardless of its physical condition. Obsolescence may be attributable to a number of causes, including technological improvements, reasonably foreseeable economic changes, and legislative or regulatory action that prohibits or otherwise limits use of the property for its intended purpose. For example, property that would be unable to meet the requirements of new air quality regulations could be rendered obsolete prior to the end of its estimated useful life. When property becomes obsolete, the property's estimated useful life would be revised and the remaining basis would be deducted over the revised useful life. In the case of property with no remaining useful life, 100 percent of the remaining basis would be deductible in the year of obsolescence.

Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

Under current federal and state income tax law, credits generated by a partnership or an S corporation generally flow through to the shareholders or partners. In general, a partner's distributive share of a credit would be determined in accordance with the partnership agreement and would flow through to the partner's return. In the case of an S Corporation, because California subjects all S Corporations to the franchise and income tax at a rate of 1.5 percent or 3.5 percent for a bank and financial, the California S Corporation tax may be offset by credits. The amount of credit allowed against the S Corporation tax is limited to one-third of the amount normally allowable under the Corporation Tax Law (CTL) and is in addition to the 100 percent flow through of the credit to the shareholders.

The CTL allows the assignment of certain eligible credits to taxpayers that are members of a combined reporting group. "Assignment" refers to the ability of a taxpayer that is a member of a combined reporting group to elect to transfer certain unused credits to a related corporation, as specified. The election to transfer any credit is irrevocable once made and is required to be made on the taxpayer's original return for the taxable year in which the assignment is made.

THIS BILL

This bill would create a refundable credit for tangible property that has been rendered obsolete by a new state regulation. The credit amount for a taxable year would be equal to the depreciation deduction that would have, except for regulatory obsolescence, been allowed for that taxable year.[1] The credit would be allowed in addition to the accelerated depreciation deduction for the remaining basis of depreciable property that becomes obsolete during the taxable year that is allowed under current law.

Under the Government Code, this bill would prohibit a state agency from "promulgating a new regulation" that would render tangible property obsolete unless an appropriation for the credit this bill would create had been made.

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[1] For example, assuming tangible property with a remaining useful life of 5 years and a remaining depreciable basis of $100 was rendered obsolete as specified. The credit would be $20 per year for 5 taxable years beginning with the taxable year that the tangible property was rendered obsolete ($100/5years=$20/yr for 5 years).

Tangible property for purposes of the credit would mean property that is described in Internal Revenue Code section 167(a). Property described in this section is depreciable property that is used in a trade or business, or property that is held for the production of income.

This bill would provide that any credit amount in excess of the tax liability would be credited against other amounts due, if any, and any remaining excess would, upon appropriation by the Legislature, be refunded to the taxpayer.

IMPLEMENTATION CONSIDERATIONS

Department staff has identified the following implementation considerations for purposes of a high-level discussion; additional concerns may be identified as the bill moves through the legislative process. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

This bill uses undefined phrases and terms: "new regulation", "obsolete", "promulgate", and "render tangible property obsolete". The absence of definitions to clarify these terms could lead to disputes with taxpayers and would complicate the administration of this credit.

This bill would apply to all new regulations issued by any state agency. If it is the author's intention that this bill would apply to specific state agencies only, this bill should be amended.

Because the credit would be subject to the promulgation of a new state regulation that renders tangible property obsolete, and the regulation would be prohibited from being promulgated until an appropriation had been made, the effective date for an underlying regulation that would trigger the operative date for the credit that this bill would allow is uncertain. For ease of administration and to prevent disputes between taxpayers and the department, the author may wish to amend this bill to specify an operative date, e.g., delaying the operative date for any affected regulations until the required appropriation had been made, to eliminate this uncertainty.

Because the bill is silent on the frequency and the amount of the required appropriation, a nominal amount could be appropriated to meet the requirements to allow for both the promulgation of a new regulation and application of the credit. If it is the author's intention that the required appropriation be of an amount and for a period that would reasonably be expected to allow for excess credits to be refunded, the author may wish to amend this bill.

Tangible property for purposes of the credit would mean all depreciable property that is used in a trade or business, or property that is held for the production of income. Under this description real property, such as a building or intangible property, e.g., a copyright, could qualify for the credit this bill would allow. If it is the author's intention to limit this credit to certain types of depreciable property, e.g., tangible personal property, this bill should be amended.

Because the bill is silent with regard to appropriations insufficient to pay refunds due, it is unclear how credits in excess of the appropriated amount would be handled. For example, would refund payments be suspended until additional funds were appropriated? Would excess refund amounts be disallowed? In the event that refunds were suspended, would interest have to be paid to refund recipients for the period of time the refund was delayed?

This bill leaves unclear whether taxpayers that are pass-through entities (partnerships and S corporations) could claim the credit and receive the refund, or whether the entity must pass through the entire credit to the investors (partners and shareholders), or whether the Franchise Tax Board would be required to refund the credit amount in some manner to both the entity and the investors. Moreover, it is unclear whether, in the case of a pass-through entity, both the entity and the investors would receive the full credit amount. For ease of implementation, it is suggested that this bill be amended to specify that the entire credit amount would be refunded to the entity that would have reported the depreciation deduction on the creditable property.

The department has never administered a refundable tax credit under the CTL. Establishing a refundable tax credit program would have a significant impact on the department's programs and operations and require extensive changes to forms and systems.

Because this bill is silent on where this credit would be applied in the hierarchy of CTL tax credits, the provisions of Revenue and Taxation Code (R&TC) section 23036(c) would apply, and, as a credit ineligible for carryforward, this credit would be applied to reduce tax first. If this is contrary to the author's intention, this bill should be amended.

Because this bill is silent on the assignment of the credit, the credit would be eligible for assignment. For example, credit assignment could be used as a strategy to utilize the refundable portion of a credit in situations where the required appropriation was insufficient to pay all the refundable credits. If this is contrary to the author's intent, this bill should be amended.

<u>TECHNICAL CONSIDERATION</u>

Subdivision (a) of R&TC section 23649.1 should be amended where the term "net tax" appears, as it should be "tax" to correspond to the definition in R&TC section 23036.

LEGISLATIVE HISTORY

Although no legislative history for a credit based on depreciation was identified, a number of bills that would create a refundable corporate tax credit have been introduced. Examples of recent proposed legislation appear below.

SB 16 (Lowenthal & Alquist, 2009/2010) would have made the low income housing credit refundable as specified. SB 16 failed to pass out of the Senate Committee on Appropriations by the constitutional deadline.

SB 151 (Denham, 2007/2008) would have created a refundable credit equal to 100 percent of the amount paid or incurred during the taxable year for qualified health expenses by a qualified employer, as specified. SB 151 failed to pass out of the Senate Committee on Revenue and Taxation by the constitutional deadline.

SB 740 (Calderon, 2007/2008) would have created a transferable credit based on wages paid and property used in connection with a qualified production made in California. The credit would have been allowed as a credit against the sales or use tax liability in lieu of the income tax credit. SB 740 failed to pass out of the Senate Committee on Revenue and Taxation by the constitutional deadline.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York.* These states do not offer a credit similar to the credit proposed in this bill. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

FISCAL IMPACT

The department's costs to administer this bill are unable to be determined until implementation concerns have been resolved. As the bill continues to move through the legislative process and implementation concerns are resolved, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

The economic impact of this bill on tax revenue is unable to be determined because it is impractical to predict what regulations will be promulgated by state agencies in the future, or the estimated value of the property that would be rendered obsolete by these regulations. Depending on the scope of future regulations, this bill could result in revenue losses on the order of millions, or tens of millions of dollars - possibly more, in some years.

SUPPORT/OPPOSITION

Support: American Home Furnishings Alliance
California Chapter of the American Fence Association
California Fence Contractors' Association
Engineering Contractors' Association
Engineering and Utility Contractors' Association
Flasher Barricade Association
Marin Builders' Association
MCM Construction

Opposition: No opposition identified to date.

ARGUMENTS

Pro: Capital investment in California's businesses is a critical component of a robust state economy. Mitigating the risk of large capital outlays losing their economic viability prematurely could encourage additional investment in the state.

Con: Some taxpayers may say that with the state facing a current, substantial deficit, and ongoing yearly deficits, additional tax expenditures should be avoided.

POLICY CONCERNS

Historically, credits have been used as an incentive to encourage taxpayers to perform various actions or activities that they may not otherwise undertake. It is possible that this bill could utilize a credit to discourage or prevent state regulatory action in certain circumstances, which is unprecedented.

Conflicting tax policies occur when a credit is provided for an expense for which preferential treatment is already allowed in the form of an expense deduction. This bill would allow a taxpayer to claim this credit and the accelerated depreciation deduction, currently allowed by law, for the same property, thus providing a double benefit. On the other hand, eliminating the double benefit would create a state and federal difference that, in this case, would affect an expense deduction and would not create an ongoing difference.

Historically, refundable credits (such as the state renter's credit, the federal Earned Income Credit, and the federal credit for gasoline used for farming) have had significant problems with invalid and fraudulent returns.

LEGISLATIVE STAFF CONTACT

Jahna Alvarado
Legislative Analyst, FTB
(916) 845-5683
jahna.alvarado@ftb.ca.gov

Patrice Gau-Johnson
Asst. Legislative Director, FTB
(916) 845-5521
patrice.gau-johnson@ftb.ca.gov