SECTION 10000 TARGETED TAX AREA BUSINESS EXPENSE DEDUCTION

References 17267.6(a); 24356.6(a)

For each taxable year beginning on or after January 1, 1998, a person or entity engaged in a trade or business within a Targeted Tax Area (TTA) may elect to treat 40% of the eligible cost of qualified property as a business expense rather than a capital expense.

The deduction is allowed for the taxable year in which the property is placed in service.

EDAM 10100	GEOGRAPHIC BOUNDARIES AND DESIGNATION DATE
EDAM 10200	QUALIFIED TAXPAYER
EDAM 10300	QUALIFIED PROPERTY
EDAM 10400	DEDUCTION AMOUNT
EDAM 10500	MAKING THE ELECTION
EDAM 10600	CREATING A NET OPERATING LOSS
EDAM 10700	ALTERNATIVE MINIMUM TAX
EDAM 10800	CHECKLIST TO DETERMINE ELIGIBILITY FOR THE BUSINESS EXPENSE DEDUCTION
EDAM 10900	RECORD KEEPING REQUIREMENTS

10100 Geographic Boundaries and Designation Date

For a listing of TTA cities, see "*TTA Locations and Designation Date*" EDAM 1340. To verify an address, refer to EDAM 1300.

10200 Qualified Taxpayer

References 17267.6(e)(1)(B); 24356.6(d)(1)(B)

EDAM 10210 Estates and Trusts
EDAM 10220 Pass-Through Entities

A qualified taxpayer is a person or entity engaged in a trade or business within the TTA and whose trade or business is described in the following Standard Industrial Classification (SIC) Manual (1987 edition) code sections:

- Codes 2000 through 2099
- Codes 2200 through 3999
- Codes 4200 through 4299
- Codes 4500 through 4599
- Codes 4700 through 5199

10210 Estates and Trusts

References 17267.6(d)(4)

Estates and trusts are not allowed to take the business expense deduction.

10220 Pass-Through Entities

The determination of whether a taxpayer is a qualified taxpayer is made at the entity level. The term "pass-through entity" means any partnership or S corporation. The business expense deduction is allowed to the pass-through entity and passed through to the partners or shareholders.

10300 Qualified Property

References 17267.6(d)(1); 24356.6(c)(1)

EDAM 10310 Leased Property
EDAM 10320 Property Not Qualified

Qualified property is IRC § 1245 property (as defined in IRC § 1245(a)(3)) purchased and placed in service for exclusive use in a trade or business conducted within the TTA. The property must also be purchased and placed in service before the date the TTA designation expires, is revoked, is no longer binding, or becomes inoperative.

Qualified property under IRC § 1245 includes, but is not limited to, tangible personal property (excluding buildings and inventory) that is subject to the allowance for depreciation. This includes most equipment and furnishings purchased for exclusive use within the TTA. Office supplies and other small non-depreciable items are not included.

10310 Leased Property

Taxpayers who acquire property by lease arrangement may be able to take the business expense deduction. The structure of the leasing arrangement itself is critical. Lease arrangements structured using a financial (conditional sales) contract generally will qualify the taxpayer to take the business expense deduction. For reference sources to determine if a lease qualifies as a purchase rather than a lease arrangement, refer to IRS Revenue Ruling 55-540, 1955-2 C.B. 39, and FTB Legal Ruling 94-2, March 23, 1994.

10320 Property Not Qualified

References 17267.6(d)(1); 17267.6(d)(2); 17267.6(d)(5); 24356.6(c)(1); 24356.6(c)(2); 24356.6(c)(4)

The business expense deduction is not allowed if the property:

- Was transferred between members of an affiliated group;
- Was acquired as a gift or inherited;
- Was traded for other property;
- Was received from a personal or business relation as defined by IRC § 267, as modified by CR&TC § 17267.6(d)(2)(A) and § 24356.6(c)(2)(A) for the TTA;
- Was received from a personal or business relation as defined by IRC § 707(b); or
- Is described in IRC § 168(f).

10400 Deduction Amount

References 17267.6(g); 24356.6(f)

EDAM 10410 Pass-Through Entities
EDAM 10420 Personal Income Tax Taxpayers-Married Filing Separate
EDAM 10430 Basis Reduction/Depreciation
EDAM 10440 Interaction with the Manufacturer's Investment Credit
EDAM 10450 Recapture

The maximum *deduction* the taxpayer may claim in any taxable year is determined by the number of years that have elapsed since the area was designated, as follows:

Taxable Years	Maximum Aggregate Cost	Maximum Deduction
Taxable year of designation and 1st year thereafter	$100,000	$40,000
2nd and 3rd taxable year thereafter	$75,000	$30,000
Each taxable year thereafter	$50,000	$20,000

10410 Pass-Through Entities

References 17267.6(d)(6)

In the case of pass-through entities, the percentage limitation (40%), of the aggregate cost of all qualified property, shall apply at the entity level and at the partner/shareholder level.

10420 Personal Income Tax Taxpayers-Married Filing Separate

References 17267.6(b)

In the case of a husband and wife filing separate returns for a taxable year, the applicable deduction is equal to one-half (50%) of the otherwise allowable deduction.

10430 Basis Reduction/Depreciation

The basis (cost for depreciation purposes) of the property is reduced by the amount allowed as a deduction. Depreciation of the cost of the property, less the amount deducted, is claimed using any method of depreciation normally allowed, beginning with the taxable year following the year in which the property is placed in service.

Taxpayers electing to take the business expense deduction cannot claim the additional first year depreciation (IRC § 179) for the same property.

10440 Interaction with the Manufacturer's Investment Credit

References 17053.49(b)(1)(C); 23649(b)(1)(C)

Taxpayers claiming the business expense deduction and the Manufacturers' Investment Credit (MIC) for the same property must reduce MIC qualified costs by the amount of the business expense deduction before computing the MIC. Taxpayers that elect to take the business expense deduction are not allowed to capitalize the expensed amount.

10450 Recapture

References 17267.6(h); 24356.6(g)

The business expense deduction is subject to recapture (added back to income) if, before the *close of the second taxable year after* the property is placed in service, the property is sold, disposed of or is no longer used exclusively within the TTA trade or business. The taxpayer is required to recapture the amount previously expensed for that item and shall include that amount as income for the taxable year in which the property ceases to be used. The basis of the property is increased as of the first day of the taxable year in which the recapture event occurs. (See Cal. Code Regs. (CCR) § 17267.2 or 24356.7 as it pertains to Enterprise Zones.)

Example: Corp. A purchases property on June 1, 1998, which qualifies Corp. A to take the TTA business expense deduction. Corp. A's taxable year ends December 31 of each year. Corp. A disposes of the property August 5, 2000. The previous deduction is added to income in the 2000 taxable year because the property was disposed of before the close of the second taxable year after the property was placed in service, 12/31/2000. The basis in the asset is increased by the recaptured amount effective January 1, 2000.

NOTE: The State Board of Equalization in an unpublished (uncitable) decision agreed that the statute requires the closure of two taxable years after the end of the taxable year in which the property is placed in service and the election to claim the deduction on the original return is made. *Appeal of Accurate Metal Fabricators, Inc., 32552, Cal.* St. Bd. Of Equal., July 3, 2000.

10500 Making the Election

References 17267.6(a); 17267.6(c); 24356.6(a); 24356.6(b)

EDAM 10510 Members of an Affiliated Group

The taxpayer must make an election to treat the cost of qualified property as a business expense on the original return filed for the taxable year the property is first placed in service. The election must specify the items to which the election applies and the portion of the cost taken into account for purposes of determining the deduction amount.

A taxpayer makes an election by filing:

- Form FTB 3809 – Targeted Tax Area Deduction and Credit Summary.

The election may not be revoked, unless the taxpayer has obtained the consent of the Franchise Tax Board.

10510 Members of an Affiliated Group

References 24356.6(c)(5)-(6)

For purposes of electing the business expense deduction, all members of an affiliated group shall be treated as one taxpayer. The maximum deduction amount shall be properly apportioned among the members of the affiliated group.

An affiliated group is defined in IRC § 1504 as modified by the California Revenue & Taxation Code, to replace "at least 80%" with "more than 50%" each place it appears in IRC § 1504(a).

10600 Creating a Net Operating Loss

Unlike IRC § 179, there is *no* statutory prohibition on the amount of business expense deduction that may create a net operating loss.

10700 Alternative Minimum Tax

References 17062; 23457

The business expense deduction is *not* listed as a tax preference item.

10800 Checklist To Determine Eligibility for the Business Expense Deduction

Checklist Items	Yes	No
Is the business qualified? • Does the business meet the applicable code section classification as described in the Standard Industrial Classification (SIC) Manual (1987 edition)? See the *Qualified Taxpayer* section (EDAM 8200).		
Is the property qualified? • Qualified property is IRC § 1245 property. See the *Qualified Property* section (EDAM 10300). • Is the property used exclusively within the boundaries of the TTA?		
Is the correct deduction amount claimed? • Limitation differs based on year of designation. See *Deduction Amount* section (EDAM 10400). • Verify purchase on invoices or receipts. • Verify the date the property is placed in service.		
Was a timely election made? • Election made on original return? • Form FTB 3809 – Targeted Tax Area Deduction and Credit Summary, or a separate statement attached to the return?		
Was the property acquired through a valid transaction? • See the *Property Not Qualified* section (EDAM 10320).		
Was correct depreciation claimed? • Basis must be reduced by the amount of the business expense deduction before depreciation is computed. • IRC § 179 expense or additional first year depreciation may not be claimed for qualified property for which the business expense deduction is claimed. • A depreciation deduction on qualified property is not allowed in the same year the business expense deduction is claimed.		
Is the deduction subject to recapture? • Was the property sold, disposed of or no longer used by the taxpayer in the area, before the close of the second taxable year after the property was placed in service? • Check current location of the qualified property. • Check sale or disposal date of qualified property.		

10900 Record Keeping Requirements

To support the business expense deduction claimed, the taxpayer must keep all records that document the purchase of the qualified property. This includes items such as purchase receipts and proof of payment. In addition, taxpayers should keep all records that identify or describe:

- The property purchased (such as serial numbers, etc.); and
- The location where the property is used