4000 ENTERPRISE ZONE BUSINESS EXPENSE DEDUCTION

References 17267.2(a); 17267.2(c); 24356.7(a); 24356.7(b)

For each taxable year, a taxpayer engaged in a trade or business within an Enterprise Zone (EZ) 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.

Taxpayers 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.

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

Note: A large number of EZs expired in 2006 and 2007 (refer to EDAM 1200 for a complete listing of expired EZs). The business expense deduction for businesses operating in an expired EZ is allowed for qualified property purchased and placed in service up to date of expiration (regardless of the ending date of a taxpayer's taxable year).

4100 Geographic Boundaries and Designation Dates

For a listing of EZs and designation dates, refer to Section 1310. To verify an address, refer to Section 1300.

4200 Qualified Taxpayer

References 17267.2(e); 24356.7(d)

A qualified taxpayer is a person or entity that conducts a trade or business within an EZ.

4210 Estates and Trusts

References 17267.2(d)(4)

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

4220 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.

4300 Qualified Property

References 17267.2(d)(1); 24356.7(c)(1)

Qualified property is IRC § 1245 property (as defined in section 1245(a)(3) of the Internal Revenue Code) purchased and placed in service for *exclusive use* in a trade or business conducted within an EZ. The property must also be purchased and placed in service *before* the date the EZ designation expires, 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 EZ. Office supplies and other small non-depreciable items are not included.

4310 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.

4320 Property Not Qualified

References 17267.2(d); 24356.7(c)

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 17267.2(d)(2)(A).
- Was received from a personal or business relation as defined by California Revenue & Taxation Code Sections 24427 through 24429, as modified by 24356.7(c)(2)(A).
- Was received from a personal or business relation as defined by IRC § 707(b).
- Is described in IRC § 168(f).
- Was placed in service prior to EZ Designation.
- Was placed in service after the EZ Expired.

4400 Deduction Amount

References 17267.2(g); 24356.7(f)

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

Taxable Years	**Maximum Aggregate Cost**	**Maximum Aggregate 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

4410 Pass-Through Entities

References 17267.2(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.

4420 Personal Income Tax Taxpayers-Married Filing Separate

References 17267.2(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.

4430 Basis Reduction / Depreciation

The basis (cost for depreciation purposes) of the property must be reduced by the amount allowed as a deduction. Normal depreciation is allowed on the cost of the property in excess of the expensed amount. The taxpayer may use any method that is allowable for California purposes, 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 allowed under IRC § 179 / CR&TC §24356 for any property.

Example: Corporation A (a calendar year taxpayer) purchases a piece of equipment for $10,000 and places it into service on January 1, 2002. For tax year 2002, the business expense deduction is $4,000 and $6,000 remains to be depreciated. If the property has a 5-year useful life, the taxpayer will deduct depreciation of $1,500 ($6,000/4) for the remaining 4 years (taxable years 2003-2006).

4440 Interaction With The Manufacturers' 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.

4450 Recapture

References Cal. Code Regs. (CCR) § 17267.2-1(a); 24356.7-1

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 EZ 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 shall be increased as of the first day of the taxable year in which the recapture event occurs.

Example: Corporation A, a calendar year taxpayer, purchased property on June 1, 2002 that qualifies Corp. A to take the EZ business expense deduction. Corp. A disposes of the property August 5, 2004. The previous deduction is added to income in the 2004 tax year because the property was disposed of before the close of the second taxable year after the property was placed in service, 12/31/2004. The basis in the asset would be increased by the recaptured amount effective January 1, 2004.

Note: The State Board of Equalization in an unpublished (non citable) decision held 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.*

4500 Making the Election

A taxpayer makes an election by filing:

- Form FTB 3805Z - Enterprise Zone Deduction and Credit Summary

4510 Members of an Affiliated Group

References 24356.7(c)(5); 24356.7(c)(6)

For purposes of electing the business expense deduction, all members of an affiliated group are treated as one taxpayer. The maximum deduction amount is 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).

4600 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.

4700 Alternative Minimum Tax

References 17062; 23457

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

4800 Checklist of Eligibility For the Business Expense Deduction

Checklist Items	Yes	No
Is the business qualified? • Is a trade or business conducted within an EZ? See the *Qualified Taxpayer* section.		
Is the property qualified? • Qualified property is Section 1245 property. See the *Qualified Property* section. • Is the property used exclusively within the boundaries of the EZ?		
Is the correct deduction amount claimed? • Limitation differs based on the taxable year since zone designation. See *Deduction Amount* section. • 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 3805Z – Enterprise Zone 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.		
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 zone, 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.		

4900 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.).
- The location where the property is used.