Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Honda | Analyst: Colin Stevens | Bill Number: AB 579

Related Bills: AB 2458 (1998) | Telephone: 845-3036 | Introduced Date: 2/19/99

Attorney: Doug Bramhall | Sponsor:

SUBJECT: Business Expense Deduction/Costs of Making Computers & Software Y2K Compliant

SUMMARY

Under the Personal Income Tax Law (PITL) and Bank and Corporation Tax Law (B&CTL), this bill would, for property placed in service in calendar years 1998 or 1999, allow taxpayers a deduction of up to $20,000 in addition to the amount specified under Internal Revenue Code (IRC) Section 179. The additional deduction would be allowed for the purchase or modification of computer software that is year 2000 (Y2K) compliant in order to replace non-Y2K compliant software, or for the purchase of a computer system required to replace a computer system where replacement is required by the Y2K problem.

EFFECTIVE DATE

This bill's provisions specify that it would apply to taxable or income years ending after December 31, 1997, for any item placed in service during 1998 or 1999.

SPECIFIC FINDINGS

Federal and state laws allow a variety of special tax credits and deductions designed to promote or influence specific taxpayer behavior believed to generate social or economic benefits for the general public. Included in state and federal law are tax incentives designed to promote business, such as accelerated depreciation of selected items and, under both federal law and PITL (but not B&CTL), allowing the deduction of the entire cost of an item in the year purchased that would otherwise be required to be deducted over a period of years. Neither state nor federal laws allow additional expensing for costs paid or incurred to make computers or computer software Y2K compliant. However, Y2K expenses, to the extent considered ordinary and necessary to conduct the taxpayer’s business, would be allowed as a deduction from gross income.

In lieu of depreciation, existing **federal law** allows both noncorporate and corporate taxpayers with a sufficiently small amount of annual investment to elect to deduct (subject to limitations) the cost of qualified property placed in service for the taxable year. Under **federal law**, the limit is $18,000 in 1997, $18,500 in 1998; $19,000 in 1999; $20,000 in 2000; $24,000 in 2001; $24,000 in 2002; and $25,000 in 2003 and thereafter. In general, qualified property is defined as depreciable tangible property that is purchased for use in the active conduct of a trade or business. The allowed amount is reduced (but not below zero) by the amount by which the cost of qualified property placed in service during the taxable year exceeds $200,000.

Board Position:			Department Director	Date
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In addition, the amount expensed for a taxable year may not exceed the taxable income for the year from the active conduct of a trade or business (determined without regard to this provision). Any amount that is not allowed as a deduction because of the taxable income limitation may be carried forward to succeeding taxable years (subject to similar limitations). A taxpayer who elects this expense deduction must reduce the depreciable basis of the qualified property by the amount of the expense deduction.

The PITL conforms to federal law that allows a qualified small business to elect to treat the cost of qualified property as an expense in the year placed in service. However, the limit is $13,000 for 1997 and $16,000 for 1998, with PITL conforming to federal limits in 1999 and later.

The B&CTL does not conform to federal expensing treatment. However, the B&CTL allows a taxpayer to deduct 20% of the cost of tangible property as accelerated depreciation in the first year the property is placed in service, to a maximum of $10,000 annually. In addition, under certain situations, such as in enterprise zones (EZs) and local agency military base recovery areas (LAMBRAs), corporate as well as personal income taxpayers may elect to treat the cost of qualified property within the zone as an expense in the year placed in service. The maximum amount allowed as an expense varies (between $20,000 and $40,000 for EZs and $5,000 and $10,000 for LAMBRAs).

Existing state and federal laws generally allow as a depreciation deduction a reasonable allowance for the exhaustion, wear, tear, and obsolescence of property used in a trade or business or property held for the production of income.

Under the federal Modified Cost Recovery System (MACRS) and state PITL, the recovery period for qualified technological equipment, including computers, is five years. The recovery period for computer software is three years.

However, the B&CTL has not conformed to MACRS. The corporate depreciation deduction is instead based on the Class Life Asset Depreciation Range System (CLADR). The recovery period guideline under the B&CTL is six years for computers and software.

Under the PITL and the B&CTL, this bill, for property placed in service in calendar years 1998 or 1999, would allow taxpayers to claim an IRC Section 179 deduction for the modification of computer software to address the Y2K problem or the purchase of computer software to replace noncompliant software.

In addition, this bill would increase the amount of the Section 179 deduction for calendar years 1998 or 1999 by the lesser of $20,000 per year or the actual cost of the modifications or software described above and the purchase of replacement computer systems necessary because of the year 2000 computer conversion problem.

Policy Considerations

This bill would create an additional difference between federal and state laws, requiring that an additional adjustment be made, increasing the complexity of preparing a California income tax return.

Moreover, taxpayers who will have already filed a 1998 tax return by the time this bill would become law would need to file an amended return to benefit from this provision, causing additional complications.

This bill potentially would provide a greater benefit to fiscal year taxpayers than for calendar year taxpayers. For example, the bill specifies that the additional deduction would apply to Y2K expenditures made during calendar year 1998 or 1999. Therefore a taxpayer whose fiscal year begins November 1 could have expenditures in the 1997-98, 98-99 and 99-2000 fiscal years while a calendar year taxpayer could use the deduction only for 1998 and 1999. This is significant since the $20,000 increase in the normal Section 179 deduction limitation would, in the example above, allow this taxpayer to deduct up to $60,000 in Y2K expenditures, while a calendar year taxpayer would be permitted to deduct only $40,000 in Y2K expenditures for amounts paid or incurred during the same time period.

To the extent that this bill would apply to software and computer systems placed in service in 1998, it would serve as a reward for behavior already undertaken rather than as an incentive to remedy Y2K problems. Moreover, the credit would reward behavior that most businesses would find necessary to undertake even without tax incentives.

Since this bill would provide a tax benefit for 1998, a year in which tax benefits will have already vested by the time this bill could be enacted, it would be considered a gift of public funds and may be held to be unconstitutional without the addition of public purpose language.

This bill and the existing Manufacturers' Investment Credit (MIC) may overlap since the MIC does not permit a taxpayer to claim the MIC with respect to any costs which are deducted under a Section 179-type expensing deduction in the year in which the property is placed in service. In particular, for taxpayers who are qualified taxpayers under the MIC, off-the-shelf computer software that is used in a qualified activity can constitute qualified property for purposes of the MIC, but would not so qualify to the extent the taxpayer deducted the costs under the provisions of this bill.

Implementation Considerations

This bill would allow taxpayers to deduct in the year placed in service the cost of computer systems and computer software (and modifications thereto) needed to make computer systems and computer software Y2K compliant. For taxpayers who have already completed their 1998 tax return, which is filed in 1999, this would require that the taxpayer file an amended return and that the department process those returns. The difficulty to administer this bill would largely depend upon the number of taxpayers who elect to amend their returns based upon this bill.

This bill, in making reference to IRC Section 179(b)(1), would change the business expense deduction allowed for 1998 to all PITL taxpayers from $16,000 to the federal limit of $18,500. Under this bill, the federal and state limits would be the same for 1999.
This increase does not appear intended by the author and if so, department staff is available to assist with amendments.

This bill is written in a style different other modifications to the Internal Revenue Code in the Revenue and Taxation Code, which could make the statute more difficult for taxpayers to understand. Department staff is available to assist the author in drafting necessary amendments to resolve this issue.

Technical Considerations

Under the B&CTL, this bill attempts to allow the expensing of costs of making computers and software Y2K compliant. However, since the B&CTL does not currently conform to IRC Section 179, this bill's attempt to modify portions of that section would have no effect. Or the bill's provisions to apply to the B&CTL, either the B&CTL would need to conform to IRC Section 179 (at least for this limited purpose) and adopt the modifications proposed in this bill, or stand-alone language would need to be written. Department staff is available to assist the author's office with necessary amendments.

Although this bill would provide a tax benefit only for years 1998 and 1999, it does not contain a sunset date. A sunset date would ensure that the bill's provisions do not remain in the law when no longer needed.

FISCAL IMPACT

Departmental Costs

If this bill is amended to resolve the implementation considerations addressed in this analysis, the bill would not significantly impact the department's costs.

Tax Revenue Estimate

The revenue impact of this bill is estimated to be as follows:

Estimated Revenue Impact For 1998 and 1999 Expenses Enactment After June 30, 1999 (In Millions)			
Fiscal Years			
1999-0	2000-1	2001-2	2002-3
($10)	$3	$4	$3

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this proposal. It does, however, assume that the intent is to permit the accelerated deduction for B&CTL taxpayers, but not to expand the B&CTL provision to full federal conformity to Section 179.

Tax Revenue Discussion

Revenue effects from this bill will depend on the amount of additional expensing deductions associated with computer system modifications and replacement reported by small businesses offset by smaller depreciation deductions in later years.

According to a Federal Reserve projection, the cost for modifications and updating computer systems to solve the year 2000 issue will cost U.S. businesses approximately $50 billion. Other sources are estimating the cost to be on the order of $75 billion. For the purposes of a revenue estimate, it is assumed that the total cost for solving the year 2000 issue would be closer to $75 billion.

Additional assumptions for the order of magnitude impact are as follows:

- California Y2K expenditures represent approximately 15% of the nation ($75 billion * 15% = $11.25 billion) of which 85% will be incurred by corporations.
- 75% of the projected total Y2K expenditures will be incurred during calendar years 1998 and 1999 (33% in 1998 and 67% in 1999).
- Firms with less than $10 million in annual gross receipts will qualify for the expense deduction under this bill.
- Of the total expenses made, firms with less than $10 million in annual gross receipts will account for 5% of expenditures by all corporations and 15% for other businesses. This is based on available gross receipt data on corporate returns.
- Approximately one-half of qualifying businesses will elect expensing Y2K deductions rather than depreciation (net loss entities, for example, will not elect).

Due to the late enactment date, it is estimated that approximately one third of qualifying taxpayers will amend prior year tax returns for expenses incurred in calendar year 1998.

BOARD POSITION

Pending.