SCS Agency
Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Hurtt | Analyst: Colin Stevens | Bill Number: SB 1995

Related Bills: See Legislative History | Telephone: 845-3036 | Introduced Date: 2-20-98

Attorney: Doug Bramhall | Sponsor:

SUBJECT: Depreciation Deduction Conformity/ACRS/Limitation for Luxury Automobiles

SUMMARY

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), this bill would conform state law to recently enacted federal law in the Taxpayer Relief Act of 1997 (TRA), including changes in the depreciation of certain clean fuel "luxury" automobiles and depreciation of rent-to-own property. Additionally, this bill would conform the B&CTL to the federal Modified Accelerated Cost Recovery System (MACRS).

EFFECTIVE DATE

As a tax levy, this bill would become effective upon enactment and would apply to property placed in service on or after January 1, 1998.

LEGISLATIVE HISTORY

AB 2029 (1996), SB 38 (Ch. 954, Stats. 1996).

SPECIFIC FINDINGS

Depreciation

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 existing **federal law**, taxpayers depreciate property using MACRS. MACRS generally requires property to be depreciated by applying one of three specified methods to the property's basis for a prescribed period. The three depreciation methods are the 200% and 150% declining balance methods and the straight-line method. MACRS lists 10 different cost recovery periods, ranging from 3 years to 50 years, depending on the type of property.

DEPARTMENTS THAT MAY BE AFFECTED:

____ STATE MANDATE ____ GOVERNOR'S APPOINTMENT

Board Position:	Agency Secretary Position:	GOVERNOR'S OFFICE USE
____ S ____ O ____ SA ____ OUA ____ N ____ NP ____ NA ____ NAR ___X_____ PENDING	____ S ____ O ____ SA ____ OUA ____ N ____ NP ____ NA ____ NAR DEFER TO ____________	Position Approved ____ Position Disapproved ____ Position Noted ____
Department Director Date G. Alan Hunter 3/30/98	Agency Secretary Date	By: Date

Federal law requires certain types of property to be depreciated under the straight-line Alternative Depreciation System (ADS). ADS has longer recovery periods and applies to such property as luxury automobiles, property used predominantly outside the United States, and tax-exempt use property.

California PITL has conformed to the federal MACRS system as in effect January 1, 1997. However, the B&CTL has never conformed to MACRS. Corporate taxpayers generally use the straight-line method, the declining balance method, or the sum of the years-digits method for depreciation purposes. The depreciation deduction is based on the Class Life Asset Depreciation Range System (CLADRS), in which the estimated useful lives are, in general, substantially longer than the recovery periods used by the federal MACRS system.

Luxury Automobiles

Under federal law prior to January 1, 1997, and current PITL and B&CTL, the amount a taxpayer may claim as a depreciation deduction for any luxury passenger automobile is limited to: $2,560 for the first year, $4,100 for the second, $2,450 for the third, and $1,475 for each succeeding year. Each dollar limitation is indexed for inflation after October 1987 by the automobile component of the Consumer Price Index.

New federal law in the TRA of 1997 added a new depreciation schedule for qualified clean-burning vehicles and certain electric vehicles built by an original equipment manufacturer by tripling the amount of depreciation that may be taken to $7,680, $12,350, $7,350, and $4,425, respectively, as adjusted for inflation. Additionally, passenger vehicles that initially used nonclean burning fuel, but are modified to permit them to be propelled by clean-burning fuel, are allowed the increased depreciation amounts and are not subject to luxury automobile limitations to the extent of the cost of the modifications. The remainder of the vehicle's cost remains subject to the depreciation limitations described under the luxury automobiles prior to the enactment of the TRA of 1997.

California conforms to federal law as it read January 1, 1997, relating to depreciation of "luxury automobiles," and has not conformed to the 1997 changes made for clean-burning vehicles.

Rent-to-Own Property

Under **current PITL and federal MACRS** as in effect January 1, 1997, rent-to-own property is classified as five-year property with a class life of more than four and less than ten years. This property includes consumer durables such as televisions, appliances or furniture, but not real property, boats, aircraft, motor vehicles or trailers.

Under **federal law** prior to January 1, 1997, taxpayers engaging in the rent-to-own business were not specifically prohibited from using the income forecast method of depreciation. Under the income forecast method, the depreciation deduction for a taxable year for property is determined by multiplying the cost of the property (less estimated salvage value) by a fraction, the numerator of which is the income generated by the property during the year, and the denominator of which is the total forecasted or estimated income to be derived from the property during its useful life. The income forecast method is generally used for

property such as motion picture films, video tapes and sound recordings. Taxpayers in the rent-to-own business also used the income forecast method to determine the allowable depreciation. The TRA of 1997 specified that taxpayers engaging in the rent-to-own business will not be allowed to use the income forecast method for rent-to-own property.

In lieu of using the income forecast method, **the TRA** of 1997 provides for a three-year recovery period for property subject to rent-to-own leases.

Current PITL has not conformed to the 1997 changes. The B&CTL also has not conformed to changes in the TRA with respect to rent-to-own property.

Property on Indian Reservations

Federal law provides accelerated depreciation for qualified property used on an Indian reservation, as defined. Qualified property means property used by the taxpayer predominantly in an active trade or business within an Indian reservation that also meets certain other tests.

The TRA made a technical clarification with respect to the definition of an Indian reservation for purposes of this depreciation provision.

The PITL has not conformed to the federal treatment for purposes of computing the MACRS deduction for qualified property used on Indian reservations. Since California’s B&CTL has never been in conformity with federal law with respect to the MACRS deduction, B&CTL is not conformed to this revised definition.

AB 1995 would conform the B&CTL to the current federal MACRS system (as amended by the TRA). MACRS depreciation therefore would apply to corporate taxpayers with respect to property first placed in service on or after January 1, 1998.

This bill would conform the PITL and B&CTL to 1997 federal changes in the treatment of clean-burning vehicles.

This bill would conform PITL and B&CTL to federal changes, providing that rent-to-own property would have a three-year recovery period and a four-year class life. However, this bill would not conform to the general federal prohibition on the use of the income forecast method for rent-to-own property.

This bill would conform the B&CTL to MACRS generally including conformity to the revised federal provisions providing accelerated depreciation for qualified property used on Indian reservations. It would not, however, conform the PITL to the revised federal provisions allowing accelerated depreciation for qualified property used on Indian reservations.

Policy Considerations

By conforming state law to federal laws, this bill would simplify the preparation of the state tax return for all affected taxpayers.

As the bill is written, it is unclear whether the author’s office intends this bill to conform without exception to MACRS as amended by the TRA or to continue to allow modifications allowed under current state law. Further

amendments would clarify the author's intent. Department staff is available to assist the author's office in resolving this consideration.

Implementation Considerations

Implementing this bill would require some changes to existing tax forms and instructions and information systems, which would not significantly impact the department's programs and operations.

Technical Considerations

Federal changes to the treatment of property used on Indian reservations and rent-to-own property was not accomplished by only modifying IRC Section 168. Rather, other IRC sections were also amended to change the treatment of these areas. Therefore, if the author intends that the changes to Indian reservations, or the income forecast method, as reflected in federal law, the bill should be amended to specifically adopt the changes made to sections other than IRC Section 168.

The PITL explicitly states that federal law on accelerated recovery of property on Indian reservations does not apply. If the author intends to adopt federal treatment of Indian reservations, this subdivision should be amended to indicate that changes made by the TRA changes shall apply to Indian reservations.

FISCAL IMPACT

Departmental Costs

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

Tax Revenue Estimate

Revenue losses under the B&CT Law are estimated to be as follows:

Effective Tax Years After December 31, 1997 Assumed Enactment After June 30, 1998 (in millions)*			
1998-9	1999-0	2000-1	2001-2
($110)	($190)	($240)	($255)

* Rounded to the nearest $5 million.

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

Tax Revenue Discussion

The above revenue impact was estimated based on the 1987 Franchise Tax Board's Bank and Corporation Tax sample. Depreciation deductions and tax revenue under existing California depreciation rule were compared with those under MACRS. The results were extrapolated to 1998 and later years based on the Department of Finance's projection of corporate profits.

Revenue losses under the provisions relating to the depreciation of luxury automobiles (as amended by PL 105-34) would be minor. Revenue losses relating to rent-to-own property also were considered and are expected to produce annual losses of under one million dollars.

Revenue impact for PITL is expected to be minor since California PITL conforms to MACRS as in effect January 1, 1997.

BOARD POSITION

Pending.