DEPARTMENT OF TAXATION
2006 Fiscal Impact Statement

1. Patron Frank W. Wagner

2. Bill Number SB 258

House of Origin:
X **Introduced**
_____ **Substitute**
_____ **Engrossed**

3. Committee Senate Finance

4. Title Machinery and Tools Tax; Valuation Methods

Second House:
_____ **In Committee**
_____ **Substitute**
_____ **Enrolled**

5. Summary/Purpose:

This bill would provide that if the owner of machinery and tools depreciates their value for federal income taxation purposes, localities must value machinery or tools placed in service on or after July 1, 2006 at their depreciated basis for federal income tax purposes. Additionally, if the owner of machinery or tools depreciates their value for federal income taxation purposes, localities would be required to value machinery or tools placed in service prior to July 1, 2006 partially based on the method currently used in the locality and partially based on their depreciated basis for federal income tax purposes on a sliding scale until the first tax year in which the assessment date is on or after July 1, 2010, when the machinery or tools would be valued at their depreciated basis for federal income tax purposes.

Under current law, localities are required to value machinery and tools, other than manufacturers' energy conservation equipment, by means of depreciated cost or a percentage or percentages of original total capitalized cost excluding capitalized interest.

The effective date of this bill is not specified.

6. Fiscal Impact Estimates are: Not available. (See Line 8.)

7. Budget amendment necessary: No.

8. Fiscal implications:

This bill would have no impact on state revenues. The revenue impact on localities is unknown. To the extent that assessments determined using the methods required by this bill differ from assessments determined under currently authorized methods, this bill would impact local revenues.

9. Specific agency or political subdivisions affected:

All localities.

10. Technical amendment necessary: No.

11. Other comments:

Machinery and Tools Tax

Article X, § 2 of the *Constitution of Virginia* provides that all assessments of real estate and tangible property are to be at their fair market value. Article X, § 1 of the *Constitution* provides that all taxes shall be uniform upon the same class of subjects within the territorial limits of the authority levying the tax.

Generally, machinery and tools used in manufacturing, mining, water well drilling, processing or reprocessing, radio and television broadcasting, dairy, dry cleaning or a laundry business are segregated as a separate class of tangible personal property and are subject to local taxation only. The tax rate imposed on machinery and tools may not be higher than that imposed on other classes of tangible personal property.

Under current law, localities are required to value machinery and tools, other than manufacturers' energy conservation equipment, by means of depreciated cost or a percentage or percentages of original total capitalized cost excluding capitalized interest. Most localities assess machinery and tools on the basis of original costs, fair market value, or book value. Frequently, a sliding scale is used, with the effective tax rate varying according to the age of the property. All cities except Lexington and Staunton use original cost as a basis of assessment. Of the 94 counties imposing the tax, 88 use original cost. Rappahannock County does not impose the tax. Eighty-two of the towns base their assessment on original costs, while the remainder use fair market value or depreciated costs.

Any proposed change in the method of valuing machinery and tools by the locality must be published in a newspaper at least 30 days before the proposed change is to take effect. Citizens may comment in writing to the local commissioner of revenue during the 30-day period regarding the changes imposed by the locality.

Federal Income Tax Depreciation

The *Internal Revenue Code* (*IRC*) allows taxpayers to deduct a reasonable allowance for the exhaustion, wear and tear of property used in a trade or business. The Modified Accelerated Cost Recovery System (MACRS) applies to tangible personal property generally placed in service after 1986. Under MACRS, the cost of property is recovered over a 3, 5, 7, 10, 15, 20, 27.5, 31.5 or 39 year period, depending on the type of property. The Accelerated Cost Recovery System (ACRS) applies to property placed in service after 1980 and before 1987. Under ACRS, the cost of property is recovered over a 3, 5, 10, 15, 18 or 19 year period, depending on the type of property. Under MACRS or ACRS, taxpayers may use the straight line method, the declining balance method, the sum of the years digits methods, or other consistent methods.

The basis of property is usually its cost. Cost is the amount paid in cash, debt obligations, or other property and services. Cost also includes amounts paid for sales tax, freight, installation and testing, excise taxes, capitalized legal and accounting fees, revenue stamps and recording fees. Under the uniform capitalization rules, all direct costs and an allocable part of most indirect costs incurred due to production and resale activities must be capitalized. Capitalized costs are included in the basis of property rather than deducted. Basis may be decreased by the IRC § 179 deduction, the deduction for clean-fuel vehicles, the credit for qualified electric vehicles, the investment credit and the tax credit or refund for buying a diesel powered highway vehicle.

Proposal

This bill would provide that if the owner of machinery and tools depreciates their value for federal income taxation purposes, localities must value machinery or tools placed in service on or after July 1, 2006 at their depreciated basis for federal income tax purposes as of the assessment date, as reflected on the income tax return of the owner filed for the period that includes the assessment date. If their owner depreciates their value for federal income taxation purposes, localities must value machinery or tools placed in service prior to July 1, 2006 as follows:

- For years in which the assessment date is on or after July 1, 2006, but before July 1, 2007, machinery or tools would be valued at the sum of four-fifths of their value obtained by the means that was in effect on January 1, 2006 and one-fifth of their depreciated basis for federal income tax purposes as of the assessment date, as reflected on the income tax return of the owner filed for the period that includes the assessment date.
- For years in which the assessment date is on or after July 1, 2007, but before July 1, 2008, machinery or tools would be valued at the sum of three-fifths of their value obtained by the means that was in effect on January 1, 2006 and two-fifths of their depreciated basis for federal income tax purposes as of the assessment date, as reflected on the income tax return of the owner filed for the period that includes the assessment date.
- For years in which the assessment date is on or after July 1, 2008, but before July 1, 2009, the machinery or tools would be valued at the sum of two-fifths of their value obtained by the means that was in effect on January 1, 2006 and three-fifths of their depreciated basis for federal income tax purposes as of the assessment date, as reflected on the income tax return of the owner filed for the period that includes the assessment date.
- For years in which the assessment date is on or after July 1, 2009, but before July 1, 2010, the machinery or tools would be valued at the sum of one-fifth of their value obtained by the means that was in effect on January 1, 2006 and four-fifths of their depreciated basis for federal income tax purposes as of the assessment date, as reflected on the income tax return of the owner filed for the period that includes the assessment date.
- For years in which the assessment date is on or after July 1, 2010, the machinery or tools would be valued at their depreciated basis for federal income tax purposes as of the assessment date, as reflected on the income tax return of the owner filed for the period that includes the assessment date.

This bill would provide that if requested by the locality, the owner of the machinery or tools would need to report information regarding the depreciated basis of the machinery or tools for federal income tax purposes.

The proposed valuation requirement would not apply to the separate classifications for machinery and tools used in harvesting forest products and for heavy construction machinery.

Additionally, this bill would provide that localities are not required to publish notice when changing the means of valuing machinery and tools when the change results in the valuation of machinery and tools at their depreciated basis for federal income tax purposes.

Other Legislation

House Bill 1290 would provide that if their owner depreciates their value for federal income taxation purposes, localities must value machinery or tools at their depreciated basis for federal income tax purposes.

cc : Secretary of Finance

Date: 01/16/2006 JEM