CAPITOL ANALYSTS NETWORK, INC.

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INVESTORS SHOULD APPRECIATE DEPRECIATION

Who says Washington can't act fast? Last Thursday, March 7, around 12:30 p.m., the House passed its fourth economic stimulus package, almost by acclamation. Within a day, the Senate agreed to accept the House bill as is, sending it flying down to the White House. President Bush promptly ignored everything else on his desk and signed this bill into law on Saturday. Perhaps inspired by Olympic athletes, it only took 48 hours for HR 3090, the "Job Creation and Worker Assistance Act of 2002," to clear the House, the Senate, and the Oval Office – record time for significant economic legislation.

The bill represents a major win for the business community that complained, accurately, it had been shut out of the $1.3 trillion ten year tax cut which passed last year. It contains three major provisions, all in effect between now and September 11, 2004:

- a $97 billion depreciation reform package,
- changes in corporate net operation loss carryback rules worth $9 billion,
- up to 13 weeks of additional unemployment benefits, extended to those who have live in states with above average unemployment and been out of work for 26 weeks, worth $14 billion

State treasurers say these reforms also will lower their tax receipts by $14 billion over the next three years. By comparison, corporate America was going to pay about $550 billion to $600 billion to the feds by September 2004.

Investors should care a lot about these deprecation changes. It will cut the average corporate tax bill by 15 percent for the next three years, then raise it by 5 percent in the following seven years. Think of this as two interest free loans, one large one from the federal government and a second smaller one from states that have conforming tax laws. **Companies planning major purchases of long lived physical capital, however, are not "average." For them, the reforms could be worth a bundle. Such companies should be increasingly numerous now that the recession is over. There is also the very real chance that corporate lobbyists win extensions before 2004.** Washington is picking favorites. To the adage, "Don't fight the Fed," we also suggest following the principle: Don't fight the Congress.

The following sections of this paper update the analysis of the CAN report published on October 22, 2201 called "Positive Tax Surprises Ahead."

Getting the Most Out of Depreciation

According to the IRS, the average U.S. corporation has pre-tax earnings of 5 cents on the dollar. Four cents of the 95 cents of its costs is for depreciation of physical capital. The tax laws for determining depreciation have a powerful effect on taxable profit, and therefore, tax liability. Boost depreciation charges from 4 cents to 6 cents and taxable income falls to 3 cents on the dollar. Tax payments fall, too, by 40 percent.

Congressional reformers have done just. Here is how. Under current law, physical capital assets placed in service today in general are lumped into categories with specified tax lives, most commonly of 3, 5,7, 10, 12, 15, 20, 27.5, or 39 years. Property with lives of 10 years or less may be depreciated under the 200 percent declining balance method., switching to straight line when that method becomes faster. Property between 12 and 20 years may be depreciated using the less rapid 150 percent declining method before switching to straight line. The curious can consult IRS Publication 946 for details. (http://ftp.fedworld.gov/pub/irs-pdf/p946.pdf)

The new law jump starts the deductions by allowing companies to deduct in the first year 30 percent of the purchase price of a capital asset, plus depreciating the remaining 70 percent of cost basis under prior rules, provided the asset has a tax life of 20 years or less. Using an 8 percent discount rate, it is possible to quantify just how generous the reformers are. All entries are expressed per dollar of physical capital purchased.

NET PRESENT VALUE OF DEPRECIATION DEDUCTIONS, 8% DISCOUNT RATE

Tax Life Class	Net Present Value of Prior Law Depreciation Deduction Stream	New Law	Subsidy as a Percent of Purchase Price
20	51 cents	66 cents	15%
15	60 cents	72 cents	12%
12	63 cents	74 cents	11%
10	71 cents	79 cents	8%
7	77 cents	84 cents	7%
5	81 cents	87 cents	6%
3	86 cents	90 cents	4%

What emerges is a plan to enhance the incentive to purchase physical capital assets with the incentive growing with the length of the tax life of the asset. Buy $1,000,000 in two-year old horses with 3 year tax lives, then the new law will cut your taxes by $40,000. Install $1,000,000 in railroad hydraulic electric generation equipment which has a tax life of 20 years, then Congress will forgive $150,000. It's not unreasonable to treat this program as providing a 4 percent to 15 percent investment tax credit for the purchase of physical capital. The 30 percent up-front bonus disappears on purchases made after September 11, 2004.

Like temporary sales tax holidays, these temporary investment credits probably won't stimulate many additional long-term purchases. If the elasticity of demand for capital assets is one, then it will induce an increase in capital purchases up to 15 percent. Therefore, at least 85 percent of such investments would be made anyway. Happy CEOs still will pocket the tax savings. Consequently, accelerating depreciation is likely to have only a small impact on long-term employment and the real economic growth rate.

However, it's unnecessary to speculate on the macroeconomic benefits to benefit as a speculator. The strategy is straightforward. Identify companies that historically purchase an above average amount of long lived physical capital. These companies will see the largest dollar drop in their taxes. Then, compare the value of their tax savings with the market capitalization of the companies. A company that will receive $500 million in present value tax benefits when the law passes, for example, should go up 10 percent if its market value now is $5 billion.

The best way to do this is to question managements directly. Ask about their plans to purchase plant and equipment in the next 2-1/2 years, especially longer lived assets. To help you, we have developed a proxy variable that should identify many of the industries where we expect the largest tax savings to be concentrated. We rely on the IRS's "Corporate Statistics of Income," which aggregates corporate tax return data into industry subtotals. The table below is for calendar year 1997. One column of their data lists "depreciation deductions" taken by industry. Another column lists "taxable income." The ratio should pinpoint fruitful sources of corporate officials to question. If tax depreciation deductions suddenly leap because of help from Washington, then industries with the highest ratios will see the most dramatic falls in their taxable incomes, and consequently in their contemporaneous tax payments. These are promising ponies to bet on. Here are 20 industries that popped up when we performed this exercise. Find companies in these industries with low price earnings ratios and you should put some of the tax savings in your pocket. You can generate your own ideas by exploring the IRS's new 1998data at http://www.irs.gov/pub/irs-soi/98co01nr.xls

Likely "Job Creation and Worker Assistance Act of 2002" Winners

	Industry	Income subject to tax ('000)	Depreciation ('000)	Depreciation/ Income subject to tax
	Total returns of active corporations	**683,792,847**	**513,137,459**	**75%**
1	Auto repair and services	888,682	7,756,937	873%
2	Auto repair; miscellaneous repair services	1,447,926	8,415,544	581%

3	Local and interurban passenger transit	196,122	942,543	481%
4	Logging, sawmills, and planing mills	440,875	1,785,451	405%
5	Gasoline service stations	291,521	934,365	321%
6	Metal cans and shipping containers	172,458	552,342	320%
7	Agricultural services, (except veterinarians),forestry, fishing, hunting and trapping	525,565	1,649,933	314%
8	Trucking and warehousing.	3,513,383	9,767,762	278%
9	Motion picture production, distribution, and services	762,917	2,114,199	277%
10	Farm-product raw materials	568,811	1,456,007	256%
11	Motor vehicles and equipment	16,398,533	40,774,069	249%
12	Railroad transportation.	1,773,474	4,015,963	226%
13	Dimension, crushed, and broken stone; sand and gravel	158,979	358,752	226%
14	Pulp, paper, and board mills	2,987,660	6,471,436	217%
15	Motor vehicle dealers	1,734,201	3,732,322	215%
16	Millwork, plywood, and related products	609,455	1,296,550	213%
17	Lumber and wood products	1,709,361	3,522,786	206%
18	Nursing and personal care facilities	595,928	1,204,100	202%
19	Agricultural production	1,808,757	3,644,428	201%
20	Medical laboratories	180,138	353,217	196%

Source: Internal Revenue Service: 1997 Corporate Statistics of Income

The Corporate Alternative Tax

Under a peculiarity of corporate tax law, companies that invest "too much" in plant and equipment during downturns can fall into the jaws of the "corporate alternative minimum tax" system. This can happen now, even before first year 30 percent depreciation acceleration is considered. To remove this disincentive, the new law temporarily waives accelerated depreciation as an item subject to the corporate alternative minimum tax. Obviously, if accelerated depreciation isn't removed, then the strategy of using tax policy to boost physical capital investment now will fail.

Summary of the "Job Creation and Worker Assistance Act of 2002"

The following summary table includes the cost estimates of the bill released last Wednesday by the Congressional Joint Committee on Taxation. The full cost estimates can be found at http://www.house.gov/jct/x-13-02.pdf. Technical explanations of HR 3090 can be read at http://www.house.gov/jct/x-12-02.pdf.

Cost Estimate for the "Job Creation and Worker Assistance Act of 2002"

($ billions)	2002	2003	2004	2005	2006	2007	2008-1012
Depreciation	(35,329)	(32,378)	(29,178)	136	18,951	18,265	43,715
NOL carryback	(7,927)	(6,623)	4,197	2,865	1,891	1,256	2,256
Unemployment Insurance	(8,515)	(4,865)	(1,015)	(340)	460	1,200	10,295
New York City Tax Benefits	(484)	(789)	(629)	(1,041)	(1,262)	(561)	(263)
Other Provisions	1,051	1,233	(2,508)	(5,033)	(3,778)	(3,214)	(3,954)
Total	(51,204)	(43,422)	(29,133)	(3,413)	16,262	16,946	52,049

Source: Joint Committee on Taxation

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