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Tax Preferences for Sport Utility Vehicles (SUVs): Current Law and Legislative Initiatives in the 109th Congress

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Summary

The growing presence of large sport utility vehicles (SUVs) on U.S. streets, roads, and highways since the early 1990s has fueled a lively debate over what steps the federal government should take, if any, to alter their effects on the environment, highway safety, traffic congestion, and overall gasoline consumption.

Legislative activity in the 108th Congress enlarged the scope of the debate to include the effect of federal tax policy on the demand for heavy-duty SUVs. In passing the Jobs and Growth Tax Relief Reconciliation Act of 2003, Congress raised the maximum expensing allowance under Section 179 of the Internal Revenue Code from $25,000 to $100,000. Heavy-duty SUVs purchased mainly for business use qualified for this allowance. Critics of SUV and their allies in Congress took exception to making large SUVs eligible for the enhanced allowance on the grounds that doing so would encourage their purchase by lowering their after-tax cost relative to smaller, more fuel-efficient vehicles. In an apparent response to this concern, the 108th Congress added a provision to the final tax bill it passed — the American Jobs Creation Act of 2004 (AJCA) — lowering the maximum expensing allowance for SUVs weighing between 6,000 and 14,000 pounds and placed in service after October 22, 2004 from $100,000 to $25,000. While it is substantial, the reduction appears to have done little to curtail the effective tax preference for large SUVs arising from the tax treatment of depreciation.

One important way in which the federal tax code can influence the purchase of heavy-duty SUVs for business use is through important differences in the tax treatment of depreciation for these vehicles and passenger cars. Under current tax law, the depreciation of passenger cars is treated less generously than that of light trucks (including many SUVs). Passenger cars, which are defined as motor vehicles weighing 6,000 pounds or less, are considered so-called "listed property" and thus subject to annual limits on allowable depreciation deductions. By contrast, light trucks, which are defined as motor vehicles weighing more than 6,000 pounds (with some exceptions), are generally depreciated under a different and more favorable set of rules. As a result, a business taxpayer can realize a greater total depreciation allowance (measured in constant dollars) over a vehicle's useful life by purchasing a heavy-duty SUV than a passenger car of comparable value.

The federal tax code also influences the purchase of heavy-duty SUVs by excluding them from the gas guzzler excise tax. The tax is levied on domestic sales of new automobiles that have relatively poor fuel economy ratings. It is paid by manufacturers and importers. Automobiles are defined as motor vehicles weighing 6,000 pounds and less. Vehicles with a gross weight above that limit are exempt from the tax.

There are no current legislative initiatives in the 109th Congress to modify these tax preferences for heavy-duty SUVs. The report will be updated to reflect significant legislative activity addressing them.

Contents

List of Tables

Sport Utility Vehicle (SUV) Tax Preferences: Current Law and Legislative Initiatives in the 109th Congress

Some regard sport utility vehicles (SUVs) as symbols of profligate consumption and a selfish disregard for highway safety, environmental protection, and fuel economy. To others, they are marvels of automotive engineering and design, offering an unrivaled combination of storage space, personal safety, rugged styling, and access to wilderness areas and other rough terrain. In the past decade, SUVs have become both an ubiquitous and conspicuous presence on American roads, streets, and highways, as their sales and average size and weight have steadily increased. Although many SUV owners use them as passenger cars, there are some notable differences in design and performance between the typical SUV and the typical passenger car. On the whole, SUVs are taller and boxier. Most are built on the rigid chassis of a pick-up truck, giving them a relatively high clearance between the road surface and the undercarriage. Partly because most SUVs have higher center of gravity than the typical passenger car, their ride typically feels bumpier and more like that of a truck, despite the availability of the same luxury options found in many automobiles. The increasing popularity of so-called crossover vehicles, which blend some of the features of passenger cars and light trucks, and a drop in domestic purchases of heavy-duty SUVs in the past year or so have lessened these differences to some extent.[1]

The effects of large SUVs on air quality, highway safety, and fuel consumption have fueled a vigorous debate over whether the federal government should subject them to more stringent regulatory standards for safety and fuel economy. Recent legislative activity by Congress has expanded the scope of debate to include the ways in which federal tax policy affects the demand for heavy-duty SUVs.

In passing the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA, P.L. 108-27), the 108th Congress pursued a variety of policy objectives, including accelerated rates of growth in domestic business investment and job creation. Congressional debate over the measure gave no indication, however, that boosting domestic demand for heavy-duty SUVs was one of these objectives. Yet a provision in JGTRRA to stimulate small business investment in machinery and equipment (including certain motor vehicles) and packaged software appears to have had such an effect. The provision made the expensing allowance under Section 179 of the Internal Revenue Code (IRC) more generous in 2003 through 2005.

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[1] See Brett Clanton, "Large SUVs Lose Luster; Cost Big 3," *Detroit News*, Jan. 16, 2005, p. 1A.

Not surprisingly, producers and sellers of heavy-duty SUVs welcomed the stimulus. They tend to earn sizable profit margins on sales of such vehicles.[2]

But not everyone was pleased that the newly enhanced expensing allowance applied to large SUVs. SUV critics denounced it as a "SUV tax loophole." They said that the allowance should be modified so that heavy-duty SUVs no longer would qualify for it. In their view, it was unacceptable for the federal government to offer a tax subsidy for the purchase of motor vehicles mainly intended for business use that from their perspective received poor gas mileage, emitted high concentrations of air pollutants, and posed significant safety hazards to their own occupants and to passengers in other vehicles.[3]

Apparently in response to the objections raised against the SUV tax preference created by JGTRRA, the 108th Congress included a provision to curtail the preference in the final tax bill it passed, the American Jobs Creation Act of 2004 (AJCA, P.L. 108-357). The provision limited the IRC Section 179 expensing allowance for SUVs exempt from the depreciation limitations for passenger cars under IRC Section 280F to $25,000. This limit applied to SUVs placed in service after October 22, 2004. AJCA also extended the changes in the allowance made by JGTRRA through 2007.

This report explains the ways in which the federal tax code might affect the purchase of heavy-duty SUVs and will discuss any proposals in 109th Congress to alter this treatment. Two statutory provisions make up the core of the report: the expensing allowance under IRC Section 179 and the gas guzzler excise tax on domestic sales of new automobiles under IRC Section 4064.

Depreciation of Motor Vehicles Under the Federal Tax Code

Perhaps the most important way in which the federal tax code affects the purchase of heavy-duty SUVs is the tax treatment of depreciation for motor vehicles other than passenger cars. In order to understand the connection between the two, it is essential to consider the current rules for writing off the cost of motor vehicles bought mainly for business use and their rationale.

In general, business taxpayers — such as subchapter C corporations, owners of S corporations, and members of partnerships and limited liability corporations — are allowed to deduct all the ordinary and necessary expenses they incur in determining

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[2] See Robert Schoenberger, "Excursion May Get Stay of Execution; High Profit Margin Offsets Low Unit Sales," *The Courier-Journal*, Oct. 29, 2003, p. 1F.

[3] See Aileen Roder and Lucas Moinester, "A Hummer of a Tax Break," *Taxpayers for Common Sense* (Washington: Jan. 23, 2003); Pamela Najor, "Tax Cut Bill 'Bad Policy', Group Says, Creating Perverse Incentives for SUVs," *Daily Report for Executives* (Washington: Bureau of National Affairs, May 28, 2003), p. G-7; and "Make Fuel-Efficient SUVs a Go, But Stop Tax Break," editorial, *Atlanta Journal-Constitution*, Oct. 27, 2003, p. 10A.

their taxable business income in a particular tax year. One such expense is depreciation, which represents the decline in the economic value of business assets resulting from wear and tear and obsolescence. Under current tax law, the cost of a depreciable asset such as a building, patent, light truck, or machine tool is recovered over a specified period — one that may or may not coincide with its actual useful life — using an allowable method of depreciation, such as the straight-line or double-declining balance methods.[4]

In an effort to bolster the domestic climate for business investment, the federal government sometimes permits taxpayers to recover the cost of certain business assets well before their economic value has been exhausted. Such an acceleration in the rate of tax depreciation encourages firms to invest more than they otherwise would in these assets in the short run, setting the stage for faster growth in the overall economy. But accelerated depreciation can also distort the allocation of economic resources by encouraging investment in favored assets at the expense of other assets which may offer higher pre-tax rates of return on investment, and into industries that intensively use the tax-favored assets at the expense of other industries whose pre-tax rates of return on investment may be higher. Accelerated depreciation can have these undesirable economic effects mainly because it lowers the user cost of capital for investment in favored assets relative to that for investment in other assets, all other things being equal.

The cost of most tangible depreciable business assets placed in service after 1986 is recovered under what is known as the Modified Accelerated Cost Recovery System (MACRS), which was established by the Tax Reform Act of 1986 (P.L. 99-514). Under this system, new and used automobiles and light trucks (including SUVs, vans, and minivans) used primarily in a trade or business are assigned a recovery period of five years. Their cost may be recovered using the most advantageous depreciation method: the double-declining balance method. Nevertheless, as is explained below, an exception to this treatment is made for passenger cars used primarily in a trade or business that the Internal Revenue Service (IRS) regards as luxurious.

In many cases, the cost of motor vehicles bought mainly for business use may also be expensed under Section 179 of the Internal Revenue Code (IRC). Generally, expensing involves writing off or deducting the cost of a depreciable asset in the year when it is placed into service, regardless of the asset's useful life. As may seem

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[4] Generally, most depreciable tangible assets placed in service after 1986 are depreciated under a system known as the Modified Accelerated Cost Recovery System (MACRS). Under MACRS, the cost of an asset is recovered by applying the proper depreciation method, the proper recovery period, and the proper convention. A taxpayer may choose to use the straight-line method, which involves writing off the same amount of the asset's acquisition cost in each year of its recovery period; its basic rate is equal to one divided by the number of years in the recovery period. Otherwise, the cost of assets in the 3-, 5-, 7-, and 10-year classes is recovered using the 200% or double-declining balance method. Under this method, the basic rate of depreciation is simply twice that of the straight-line method. The cost of assets in the 15- and 20-year classes is recovered using the 150% declining balance method, whose basic rate is 1.5 times larger than that of the straight-line method. Longer-lived assets must be depreciated using the straight-line method.

obvious, expensing is the most accelerated form of depreciation. Owing to changes in Section 179 made by JGTRRA and AJCA, business taxpayers may expense in a tax year up to $100,000 of the cost of qualified assets placed in service from 2003 through 2007;[5] before JGTRRA, the maximum expensing allowance in that period was fixed at $25,000.[6] With a few minor exceptions, qualified assets are defined as new and used business machines and equipment (including motor vehicles) and packaged or off-the-shelf software used in the active conduct of a trade or business. The amount that a business taxpayer may expense under Section 179 is subject to two important limitations: a dollar limitation and an income limitation. Under the dollar limitation, the maximum annual expensing allowance of $100,000 is reduced, dollar for dollar, by the amount by which the total cost of qualified property placed in service in a single tax year exceeds a phase-out threshold of $400,000 from 2003 through 2007;[7] that threshold was fixed at $200,000 before the enactment of JGTRRA. Under the income limitation, the expensing allowance cannot exceed the taxable income a taxpayer earns from the active conduct of the trade or business in which the qualified assets are used. Assuming no change in current law, the maximum expensing allowance will revert to $25,000 and the phase-out threshold to $200,000 in 2008 and beyond.

A critical aspect of the expensing allowance is its impact on small business. Because of the phase-out threshold, most of the firms able to take advantage of the allowance are relatively small in asset, employment, or revenue size.

In addition, new (but not used) motor vehicles used primarily in a trade or business were among the business assets that qualified for temporary first-year depreciation deductions of 30% under the Job Creation and Worker Assistance Act of 2002 (JCWAA, P.L. 107-147) and 50% under JGTRRA. The 30% deduction applied to qualified property acquired after September 10, 2001, and before January 1, 2005, and placed in service before January 1, 2005.[8] And the 50% deduction applied to the same set of assets acquired after May 5, 2003, and before January 1, 2005, and placed in service before January 1, 2005. Business taxpayers could claim

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[5] This amount is indexed for inflation in 2004 through 2007. As a result, the maximum expensing allowance in 2004 was $102,000.

[6] For more details on the expensing allowance and how it was altered by JGTRRA, see CRS Report RL31852, *Small Business Expensing Allowance Under the Jobs and Growth Tax Relief Reconciliation Act of 2003: Changes and Likely Economic Effects*, by Gary Guenther.

[7] This amount is also indexed for inflation in 2004 through 2007. As a result, the phase-out threshold in 2004 was $410,000.

[8] The 30% and 50% temporary depreciation allowances were available for new assets that were depreciable under the MACRS and had recovery periods of 20 or fewer years. They also applied to water utility property, computer software that was depreciable over three years under IRC Code 167, and qualified leasehold improvements.

Some property can be placed in service in 2005 still qualify for the allowances. Specifically, the property must be produced by a business taxpayer and subject to the uniform capitalization rules under IRC Section 263A, have a production period of more than two years or more than one year and a cost exceeding $1 million, and have a recovery period under the MACRS of at least 10 years or be used in the business of transporting people for hire.

either deduction, but not both. In effect, they operated as partial expensing allowances, and firms of all asset, employment, or revenue sizes and forms of legal organization were able to benefit from them.

It is possible for a business taxpayer to claim all three depreciation allowances for a new motor vehicle bought and placed in service in 2004. The key considerations are the cost of the vehicle, the total cost of assets eligible for the Section 179 expensing allowance that were placed in service in 2004, and the business share of the vehicle's total use. If the cost of a vehicle is sufficiently large, the total cost of eligible assets sufficiently small, and business use accounted for more than 50% of total use, then all three depreciation allowances may be claimed. In doing so, a prescribed sequence must be followed. First, the taxpayer determines whether an expensing allowance can be claimed. If so, then any allowance that is claimed has to be deducted from the taxpayer's basis in the vehicle.[9] If the adjusted basis is greater than zero, then the taxpayer may claim either the 30% or 50% temporary first-year depreciation deduction. This deduction of course further reduces the taxpayer's basis in the vehicle. If upon further adjustment the basis still is positive, then the taxpayer may claim the depreciation allowances permitted under MACRS in 2004.

Domestic Demand for SUVs and the Debate Over Their Social Welfare Effects

Sport utility vehicles are classified as light trucks in existing data on domestic motor vehicle sales and production. In 2003, U.S. motor vehicles sales totaled 16.967 million units.[10] Of that number, light trucks accounted for 53%, followed by passenger cars (45%) and medium and heavy trucks (2%). Sales of light trucks exceeded those of passenger cars for the first time in 2001. In 1992, by contrast, the share of passenger cars was nearly double that of light trucks: 63% to 35%.

A major reason for the rise in the light-truck share of domestic motor vehicle sales since the early 1990s has been the increasing popularity of SUVs. U.S. sales of SUVs jumped from less than a million units in the early 1990s to around 4.5 million units in 2003.[11] Automobile manufacturers have contributed to the growth in domestic ownership of SUVs by spending substantial sums on developing, producing, and marketing these vehicles in the past decade or so.[12] Fueling this heavy investment has been the prospect of reaping substantial returns. In 1998, the Ford Motor Company reportedly earned about $2.4 billion in after-tax profits from

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[9] Generally, a taxpayer's basis in an asset is the value of the original capital investment. In most situations, it is the cost of the asset to the taxpayer.

[10] Standard & Poor's, *Industry Surveys: Autos & Auto Parts* (New York: June 24, 2004), p. 13.

[11] Brett Clanton, "SUV Glut Signals Dip in Interest," *Detroit News*, Aug. 13, 2004, p. A1.

[12] Spending on SUV advertising in the United States rose from $172.5 million in 1990 to $1.51 billion in 2000. See Keith Bradsher, *High and Mighty* (New York: Public Affairs, 2002), p. 112.

sales of two of its SUV lines, the Expedition and Navigator.[13] And one analyst estimated that an SUV with a 2003 sticker price of $50,000 might yield a profit of $20,000 or more, whereas the profit on a minivan might be one tenth as much.[14]

The steady rise in domestic ownership of light trucks in general and SUVs in particular since the early 1990s has fueled an increasingly lively debate over their impact on highway safety, air quality, and U.S. reliance on foreign sources of crude oil and petroleum products, among other topics.[15] Critics charge that SUVs, especially the heaviest ones, wastefully consume gasoline, contribute more to air pollution and global warming than passenger cars, and pose a significant threat to the safety of their own passengers, as well as other people on the road. Owners of the vehicles, by contrast, retort that SUVs in general and large ones in particular offer greater protection to passengers than smaller vehicles and are much safer than critics contend. They also argue that in a democratic society, consumers should be free to own heavy-duty motor vehicles if they place a high value on personal safety and comfort.

This much seems beyond dispute in the ongoing discussion about the social welfare effects of SUVs. SUVs have accounted for an increasing share of total fuel consumption and emissions by motor vehicles in the past decade. On average, their gas mileage has been lower, their emissions of carbon monoxide and nitrogen oxides higher, and their risk of rolling over in an accident greater than most passenger cars.[16] And relative to passenger cars, SUVs face less stringent federal standards for fuel economy and emissions, and their safety record is thought to receive less scrutiny from federal agencies.[17] But several recent public announcements by federal regulatory agencies and manufacturers of SUVs have raised the possibility that these discrepancies might shrink or disappear in coming years.[18]

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[13] Ibid., p. 89.

[14] Jonathan Weisman, "Businesses Jump on an SUV Loophole; Suddenly $100,000 Tax Deduction Proves a Marketing Bonanza," *Washington Post*, Nov. 7, 2003.

[15] For an overview of the principal arguments made by proponents on both sides of this debate, see Cooper, "SUV Debate," pp. 451-461; Gregg Easterbrook, "America's Twisted Love Affair With Sociopathic Cars," *New Republic*, vol. 228, Jan. 20, 2003, pp. 27-34; and Sam Kazman, "Is Big Bad?: SUV Critics Hold Consumers in Contempt," *Reason*, Aug./Sept. 2003, available at [http://www.cei.org].

[16] Cooper, "SUV Debate," pp. 453-458.

[17] See Cooper, "SUV Debate," p. 454; and CRS Report RS20298, *Sport Utility Vehicles, Mini-Vans, and Light Trucks: An Overview of Fuel Economy and Emissions Standards*, by Brent D. Yacobucci.

[18] The Environmental Protection Agency issued a final rule in February 2000 that beginning with the 2009 model year (MY), all light trucks, including SUVs, will be held to the same emissions standards as passenger cars (see 65 Federal Register 6698, Feb. 10, 2000). In addition, in December 2002, the Department of Transportation proposed that starting with MY2005, all light trucks, including SUVs, will be subject to higher fuel economy standards. Under the rule, their average fuel economy would rise from the current requirement 20.7 miles per gallon (mpg) to 21.0 mpg in MY2005, 21.6 mpg in MY2006, and 22.2 mpg in

(continued...)

Tax Treatment of Depreciation for SUVs

The tax treatment of depreciation for an SUV hinges on the vehicle's weight. Depending on its weight, a vehicle may be classified as either a passenger car or a light truck for federal tax purposes. This distinction has important implications for the number of tax years required to recover the cost of an SUV and the present value of total depreciation allowances that may be claimed.

In general, current federal tax law imposes limits on depreciation deductions for passenger cars that do not apply to light trucks. For tax purposes, passenger cars are defined as four-wheeled vehicles made primarily for use on public streets, roads, and highways and having an unloaded gross vehicle weight (i.e., curb weight fully equipped for service but without passengers or cargo) of 6,000 pounds or less. Under this definition, most trucks, vans, minivans, and SUVs built on an automobile chassis with a gross vehicle weight (i.e., maximum total weight of a loaded vehicle as specified by the manufacturer) of 6,000 pounds or less are subject to the same depreciation rules as passenger cars.[19]

As was noted earlier, motor vehicles in general are assigned a class or depreciation life of five years under the MACRS. But the depreciation of passenger cars is subject to annual limits under IRC Section 280F, and these limits may extend the period required to recover their costs beyond five years. This statutory provision, which was added to the federal tax code by the Deficit Reduction Act of 1984 (P.L. 98-369), establishes a new category of tangible depreciable assets known as listed property. In general, listed property covers assets whose nature or functional purpose readily allows for both business and personal use. Under current law, passenger cars and other transportation equipment; property used in entertainment, recreation, or amusement; computers and peripheral equipment; and cellular telephones and similar telecommunications equipment are considered listed property. This property is

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[18] (...continued)
MY2007 (see 67 Federal Register 77015-77029, Dec. 16, 2002). Finally, in early December 2003, 15 automobile makers from four nations voluntarily agreed to redesign the SUVs and pick-up trucks they sell in the United States to make them less dangerous to the occupants of passenger cars. The announced design changes are to be phased in so that all MY2010 light trucks will incorporate them. Many of the largest SUVs and pick-up trucks sold domestically will need to be redesigned. Because the action is being taken voluntarily, it is unclear what role federal regulatory agencies will play in the redesign effort. (See Danny Hakim, "Automakers to Redesign S.U.V.'s to Reduce Risks," *New York Times*, Dec. 4, 2003, p. A1; and Lorrie Gilbert, "Automakers Announce Plans to Improve Designs for Vehicle Occupant Protection," *Daily Report for Executives*, Bureau of National Affairs, Dec. 5, 2003, p. A-37.)

[19] Under temporary rules (T.D. 9069) issued by the Internal Revenue Service on July 7, 2003, certain vans and light trucks weighing 6,000 pounds or less have not been treated as passenger cars for tax purposes since the 2003 tax year. More specifically, the exclusion applies to vans and light trucks that are modified for business use in a way that precludes any personal use. The rules were issued in response to swelling complaints from small business owners that current dollar limits on depreciation deductions for passenger cars were making it impossible to write off the cost of a basic model van or light truck in the five years permitted under MACRS.

subject to specific dollar limits on the amount that may be deducted for depreciation in a single tax year, assuming business use accounts for 50% or more of total use of the property.[20] If business use accounts for all of a listed property's total use, then the maximum depreciation allowance may be claimed for a tax year. But if business use represents less than 100% of the property's total use, then the depreciation allowance that may be claimed is proportional to the business share of total use.[21]

In the case of passenger cars, the limits under IRC Section 280F represent the maximum annual depreciation deductions that may be claimed under a combination of the MACRS, the IRC Section 179 expensing allowance, and the temporary 30% and 50% first-year depreciation deductions established by JCWAA and JGTRRA (if applicable). For passenger cars placed in service in 2004, a business taxpayer may claim a depreciation allowance for that tax year of $10,610 if he or she claims the 50% deduction.[22] The limits began in 1984 and have been adjusted for inflation since 1988. Although their original intent was to discourage the purchase of luxury cars for business use, the limits no longer effectively serve this purpose because they have not kept pace with increases in the cost and improvements in the quality and design of passenger cars.[23] The federal tax code does not define a luxury passenger car, but its dollar value for a new car placed in service in a tax year is determined by the sum of the depreciation limits for each of the first five years of the vehicle's useful life. Thus, for cars placed in service in 2004 and disregarding the temporary depreciation deduction of 50% under JGTRRA, any passenger car costing $13,960 or more was considered luxurious.

Pick-up trucks, vans, and minivans built on a truck chassis with a gross vehicle weight of more than 6,000 pounds are considered light trucks for tax purposes and thus exempt from the depreciation limitations for luxury passenger cars under IRC Section 280F.[24] The exemption originated with the Deficit Reduction Act of 1984 and was intended to exclude heavy-duty working vehicles such as pickup trucks used in farming or construction or heavy vans used by the self-employed. As a result, the cost of excluded vehicles may be recovered under the same statutory provisions

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[20] If business use of listed property drops below 50% of total use, the property must be depreciated under the MACRS alternative depreciation system (ADS), which tends to be much less generous than the regular MACRS. Property whose cost is recovered under the ADS is not eligible for the 30% or 50% temporary first-year depreciation allowances under JCWAA and JGTRRA, respectively.

[21] For example, if the business share of total use for a passenger car is 75%, then the depreciation deduction that may be claimed in a particular tax year is 75% of the maximum allowed under IRC Section 280F.

[22] See IRS Revenue Procedure 2004-20. For passenger cars subject to the temporary 50% first-year depreciation allowance, a business taxpayer may claim depreciation deductions of $4,800 in 2005, $2,850 in 2006, and $1,675 in each succeeding tax year.

[23] See U.S. Congress, Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, JCS-41-84 (Washington: GPO, 1985), pp. 559-560.

[24] SUVs belonged to this category of vehicles before the enactment of the American Jobs Creation Act of 2004.

governing the depreciation of motor vehicles other than luxury passenger cars. Permissible depreciation deductions for light trucks placed in service in 2004 reflected the application of the IRC Section 179 expensing allowance, the 50% temporary first-year depreciation deduction, and the MACRS. Small business owners, including self-employed individuals, are the taxpayers most likely to claim all three deductions.

Among other things, AJCA carved out a niche in IRC Section 179 for SUVs built on a truck chassis with a gross vehicle weight of more than 6,000 pounds. These vehicles are not subject to the limitations on depreciation deductions mandated under IRC Section 280F. Under the act, these vehicles were defined as any four-wheeled vehicle designed mainly "to carry passengers over public streets, roads, or highways" with a gross vehicle weight of under 14,000 pounds. Because this definition could apply to many heavy pickup trucks, vans, and small buses, as well as SUVs, it is further refined to exclude them from the limitation on depreciation deductions for heavy-duty SUVs.[25] The act limited the cost of SUVs with a gross vehicle weight of more than 6,000 pounds and less than 14,000 pounds that may be expensed to $25,000.[26] This rule applies to vehicles placed in service after October 22, 2004.

Accelerated Depreciation and Demand for Heavy-Duty SUVs

What does the current tax treatment of depreciation for motor vehicles mean for the demand for heavy-duty SUVs? It is difficult to assess the impact of federal tax law on domestic sales of any depreciable asset. Nevertheless, there is reason to believe that current law encourages the purchase of heavy-duty SUVs for business use over lighter SUVs or passenger cars of comparable value. The reason lies in the tax subsidy available to business taxpayers who buy an SUV not subject to the depreciation limitations on luxury passenger cars. This subsidy increased significantly under JGTRRA but was reduced somewhat under AJCA.

This subsidy can be illustrated from the data in the following table. It compares the maximum first-year depreciation deductions a business taxpayer may claim and

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[25] The following vehicles are excluded from the definition of SUVs under IRC Section 179(b)(6)(B)(i): (1) those designed to have a seating capacity of more than nine persons behind the driver's seat; (2) those equipped with a cargo area of at least six feet in length that is an open area and is not readily accessible from the passenger compartment; (3) those equipped with a cargo area of at least six feet in interior length that is designed for use as an open area but is enclosed by a cap and is not readily accessible directly from the passenger compartment; and (4) those with an integral enclosure spanning the driver compartment and load-carrying device, no seating behind the driver's seat, and no body section protruding more than 30 inches ahead of the leading edge of the windshield.

[26] Under JGTRRA, the maximum expensing allowance for SUVs weighing more than 6,000 pounds was $100,000. So any such SUV bought and placed in service from January 1 2004 through October 22, 2004 was eligible for that allowance. AJCA reduced it to the amount that was in effect in 2003 before the enactment of JGTRRA.

the present value of the total depreciation allowances (in 2004 dollars) the taxpayer may claim as a result of purchasing and placing in service in 2004, both before and after the enactment of AJCA a new SUV weighing more than 6,000 pounds and a new passenger car of equal value.[27] In computing the depreciation deductions, it is assumed (perhaps implausibly) that each vehicle is driven solely for business purposes, that the taxpayer earns at least $40,000 in 2004 from the trade or business in which the vehicle is used, and that the double-declining balance method of depreciation with the half-year convention is used. And in computing the present value of the total depreciation allowances claimed for each vehicle, it is assumed that the discount rate is 5%.

Table 1. First-Year Depreciation Deductions and Present Value of Total Depreciation Deductions for Two Motor Vehicles Placed in Service in 2004 Before and After the Enactment of the American Jobs Creation Act of 2004

Vehicle	**New Heavy-Duty SUV**		**New Passenger Car**
Assumed Curb Weight (pounds)	6,400		3,200
Purchase Price	$40,000		$40,000
Maximum First-Year Depreciation Allowance[a]	**Under the American Jobs Creation Act of 2004**	**Before the American Jobs Creation Act of 2004**	**$10,610**
	$34,000[b]	**$40,000[c]**	
Years Required to Recover the Acquisition Cost[d]	6	1	16
Present Value of Total Depreciation Deductions (2004 dollars)[e]	**$39,387**	**$40,000**	**$32,022**

Source: Congressional Research Service

a. The passenger car is subject to annual limits on depreciation deductions under IRC Section 280F. The SUV is not subject to any such limits and thus is eligible for the maximum expensing allowance allowed under IRC Section 179, along with the 50% temporary depreciation deduction in effect during 2004 and the regular depreciation allowance under the MACRS.

[27] Examining first-year depreciation allowances offers a useful and illuminating frame of reference because the tax benefits linked to accelerated depreciation depend on the proportion of an asset's acquisition cost recovered in the first year or two of its tax life. These benefits increase as the proportion expands and a depreciable asset's tax life lengthens. The fundamental reason lies in the time value of money and its relation to the tax deferral made possible by accelerated depreciation: tax savings realized today are more valuable than the same amount of tax savings realized over five or 10 years.

b. The figures in this column reflect the current limit of $25,000 on the maximum expensing allowance in a single tax year for an SUV with a gross vehicle weight of over 6,000 pounds but less than 14,000 pounds. This limit was established by the American Jobs Creation Act of 2004.

c. The figures in this column reflect the limit of $102,000 on the maximum expensing allowance in 2004 for SUVs with a gross vehicle weight of more than 6,000 pounds. This limit was in effect before the enactment of the American Jobs Creation Act of 2004.

d. According to IRS Revenue Procedure 2004-20, the maximum depreciation allowance in 2004 for a passenger car eligible for the 50% temporary depreciation deduction and placed in service that year was $10,610, followed by $4800 in 2004, $2850 in 2005, and $1,675 in each succeeding year. The SUV is depreciated using the double-declining balance method with a half-year convention.

e. In estimating the present value of total depreciation allowances, it is assumed that the discount rate is 5%.

The results indicate that a business taxpayer would realize higher after-tax returns on investment and a greater cash flow in the short run by purchasing the SUV instead of the passenger car. This conclusion is warranted by the differences among the three scenarios in the present value of total depreciation deductions. The greater the present value, the lower the tax burden on the returns to investment in a depreciable business asset. The present value in 2004 dollars of total depreciation allowances for the SUV under an expensing allowance of $102,000 is 20% greater than the present value of those allowances for the passenger car; the difference drops to 19% when the maximum expensing allowance for the SUV is reduced to $25,000.

Perhaps the most surprising finding is that there is little difference (1.5%) between the present value of total depreciation allowances for the SUV under the current version of IRC Section 179 and the one in effect under JGTRRA before the enactment of AJCA. At least in this example, the sharp reduction in the maximum expensing allowance for heavy-duty SUVs under AJCA did little to curtail the tax subsidy for investment in these vehicles offered by current depreciation rules.

Is there any evidence that the faster depreciation of heavy-duty SUVs relative to comparable lighter motor vehicles under current tax law has increased domestic sales of these vehicles? It is not known to what extent this tax preference has affected domestic sales of light trucks weighing over three tons. Available evidence seems mixed. On the one hand, some press reports suggested that the availability of the preference, efforts by dealers to spur sales by making customers aware of it through local advertising campaigns, and initiatives being considered in Congress to eliminate or curtail the stronger preference created by JGTRRA partly explained why domestic sales of full-size and luxury SUVs were surprisingly strong in December 2003 and January 2004.[28] On the other hand, U.S. sales of the heaviest SUVs declined by 6% in 2004 compared to 2003, even though for much of the year the

[28] See Jim Hopkins, "SUV Sales Climb on Tax Loophole; Small Businesses Discover Benefit," *USA Today*, Feb. 11, 2004, p. B3.

maximum expensing allowance for the vehicles was four times greater than its present value.[29]

Of course, the decision to purchase a motor vehicle primarily for business use hinges on more factors than its depreciation for tax purposes. The income and tastes of the business owner, present and expected future gasoline prices, and the relative prices and average expected gas mileage of alternative vehicles also influence the decision. Owing to the limitations on the use of the IRC Section 179 expensing allowance, small business owners and self-employed individuals are the business buyers of motor vehicles whose decisions would be influenced the most by the tax subsidy for heavy-duty SUVs.

Gas Guzzler Excise Tax

The tax treatment of depreciation for heavy-duty SUVs is not the only way in which the federal tax code might encourages the purchase of these vehicles. IRC Section 4064, which imposes an excise tax on sales by manufacturers or importers of new automobiles failing to meet statutory standards for fuel economy, also offers consumers (including small business owners) an incentive to prefer heavy-duty SUVs to motor vehicles that are more economical in fuel consumption. This tax is known as the gas guzzler tax.

The gas guzzler tax, which originated with the Energy Tax Act of 1978 (P.L. 95-618), applies to domestic sales of automobiles by manufacturers and importers. IRC Section 4064(b) defines an automobile as any "4-wheeled vehicle propelled by fuel which is manufactured primarily for use on public streets, roads, and highways, and which is rated at 6,000 pounds unloaded gross vehicle weight or less." Certain vehicles matching this description are exempt from the tax, including emergency vehicles such as ambulances and police cars. The amount of the tax levied on each make and model of automobile depends on its combined city and highway fuel economy rating, which is defined as the average number of miles traveled by an automobile per gallon of gasoline as determined by the Environmental Protection Agency. Presently, the tax ranges from $1,000 for cars with a fuel economy rating of at least 21.5 miles per gallon but less than 22.5 miles per gallon to $7,700 for cars that have a rating of less than 12.5 miles per gallon; cars with a rating of 22.5 miles per gallon and above avoid the tax. These amounts have been in effect since the enactment of the Omnibus Budget Reconciliation Act of 1990 (P.L. 101-508). The Internal Revenue Service, which administers the tax, issued the initial regulations implementing it in 1980. In FY2003, the tax raised $126.685 million in revenue, up from $70.788 million in FY2000 and $52.641 million in FY1996.

The tax appears to serve two related policy goals. It clearly seeks to promote the development, manufacture, and sale of fuel-efficient cars by raising the average cost of producing cars with relatively low gas mileage (and thus subject to the tax) relative to that of cars with relatively high gas mileage (and thus exempt from the

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[29] Brett Clanton, "Large SUVs Lose Luster, Cost Big 3," *Detroit News*, Jan. 16, 2005, available at [http://www.detnews.com].

tax). At the same time, the tax can be seen as an effort to mitigate the negative social costs or deleterious effects of driving relatively fuel-inefficient cars. Prominent among these effects is the added air pollution these vehicles cause. To the extent that the excise tax raises the unit production cost for low-mileage cars, it causes manufacturers to bear at least some of the social cost of this pollution.

The Gas Guzzler Tax and the Demand for Heavy-Duty SUVs

The gas guzzler tax does not apply to motor vehicles weighing in excess of 6,000 pounds. Therefore, heavy-duty SUVs are exempt from it. As a result, demand for these SUVs is no doubt greater than it would be if they were subject to the tax. Since many of these vehicles get relatively low gas mileage, it is conceivable that retail prices could be as much as $2,000 to $7,700 higher for many models if current law were changed to subject sales of heavy-duty SUVs to the tax and manufacturers and dealers passed the full amount of the tax on to buyers. According to one estimate, the U.S. Treasury loses billions of dollars in revenue each year because of the exemption of light trucks (including SUVs) from the tax.[30]

How would domestic sales of heavy-duty SUVs respond to the imposition of the gas guzzler tax? The answer of course hinges on how much of the tax would be passed on to consumers and the sensitivity of demand for heavy-duty SUVs to increases in retail prices. While manufacturers and importers would be legally obligated to pay the tax, it is far from certain that they would also end up bearing its entire economic burden through declines in the revenue they receive from domestic SUV sales. They could attempt to shift some or all of the tax to their employees through lower compensation; or to suppliers of needed materials, parts, and components through lower prices; or to buyers of heavy-duty SUVs through higher retail prices. The distribution of the economic burden of the tax between manufacturers and consumers ultimately hinges on the price sensitivity (or elasticity) of demand for and supply of heavy-duty SUVs. To maintain their sizable profit margins on sales of heavy-duty SUVs, manufacturers presumably would want to pass the entire amount of the tax onto buyers, but they would be constrained by the prospect of potential buyers losing interest in the vehicles if retail prices were to rise because of the tax. In general, producers are likely to bear much of the burden of a tax like the gas guzzler excise tax if demand is more sensitive to price changes than supply in the short run; however, consumers are likely to bear much of the burden if demand is less sensitive to price changes than supply in the short run. Unfortunately, the data needed to estimate these sensitivities for heavy-duty SUVs are not publicly available.

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[30] A 2000 study issued by the environmental advocacy group Friends of the Earth concluded that domestic and foreign automobile manufacturers avoided paying $10.2 billion in gas guzzler excise taxes in 1999 and $43.1 billion from 1995 through 1999 because of the exemption of light trucks from the tax. It is not clear from the study what assumptions were made in arriving at this estimate. See Friends of the Earth, *Gas-Guzzler Loophole: SUVs and Light Trucks Drive Off with Billions* (Washington: 2000), available at [http://www.foe.org].

Legislative Initiatives in the 109th Congress to Reduce or Eliminate SUV Tax Preferences

No legislation to curtail or enhance current tax preferences for heavy-duty SUVs has been introduced in the 109th Congress. It is uncertain whether the issue will receive attention in coming months. Efforts to curtail the preferences would run into opposition from the automotive industry and its allies in Congress. But efforts to enhance them would arouse opposition from environmentalists and their allies in Congress.

The issue did surface in some legislation considered in the previous Congress. Identical bills to subject SUVs weighing more than 6,000 pounds to the same annual depreciation limits that apply to passenger cars under IRC Section 280F was introduced in the House (H.R. 727/Representative Eshoo) and the Senate (S. 265/Senator Boxer). The measures defined a sports utility vehicle as any motor vehicle that has the "primary load-carrying device or container attached" and a seating capacity of 12 or fewer individuals and is designed to seat nine or fewer individuals behind the driver's seat, irrespective of the vehicle's weight. In addition, the bills specified that vehicles equipped with an "open cargo area or a covered box not readily accessible for the passenger compartment" of a minimum interior length of 72 inches, an integral enclosure that fully surrounded the driver compartment and load-carrying device, or a body section that extended "more than 30 inches ahead of the leading edge of the windshield" would be excluded from the depreciation limits. No action was taken on either bill.

Nonetheless, there was enough support in the 108th Congress for a reduction in the subsidy for purchases of heavy-duty SUVs for business use available through the tax treatment of depreciation for motor vehicles that such a reduction was included in the conference agreement on H.R. 4520 (the American Jobs Creation Act of 2004, P.L. 108-357) approved by the House and Senate in October 2004. More specifically, the agreement contained a provision limiting the IRC Section 179 expensing allowance to $25,000 for heavy-duty SUVs, instead of the maximum allowance of $100,000 allowed under previous law. Such an SUV was defined as "any four-wheeled vehicle which is primarily designed or which can be used to carry passengers over public streets, roads, or highways, which is not subject to IRC Section 280F, and which is rated at not more than 14,000 pounds gross vehicle weight." The provision was originally included in a tax bill (S. 1637) passed by the Senate on May 11, 2004. In its consideration of H.R. 4520 as passed by the House, the Senate substituted the text of S. 1637 as an amendment and passed it. According to estimates by the Joint Committee on Taxation, the limited expensing allowance for SUVs could yield a revenue gain of $223 million from FY2005 to FY2009. President Bush signed H.R. 4520 into law on October 20, 2004.

There was less interest in the 108th Congress in modifying the gas guzzler tax to make it applicable to heavy-duty SUVs. Senator Durbin introduced a bill (S. 795) that would have done so. But it attracted no co-sponsors, and the Finance Committee took no action on it. The measure would have altered the definition of an automobile so that the gas guzzler tax would apply to motor vehicles with an unloaded gross vehicle weight of 12,000 pounds or less. Such a limit would have covered every

heavy-duty SUV presently sold in the United States. Under the proposal, light trucks used primarily for business such as vans and pick-up trucks would have been exempt from the tax