Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

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Related Bills:	See Legislative History	Telephone:	845-6979	Introduced Date:	04/04/2001
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Electrical Power Generation Windfall Profits Tax

SUMMARY

This bill would impose a windfall profits tax on electrical businesses, including power generators that sell electricity for an excessive profit.

PURPOSE OF THE BILL

The purpose of this bill appears to be to respond to perceived manipulation of the electricity market to increase prices by companies that generate or sell electricity.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would be operative for taxable years beginning on or after January 1, 2001.

POSITION

Pending.

Summary of Suggested Amendments

Amendments are needed to resolve how the windfall profits tax will be assessed. See “Implementation Considerations” below. Department staff is available to assist the author with amendments.

ANALYSIS

<u>BACKGROUND</u>

Nexus is a constitutional requirement that must be satisfied before a state can properly exercise its power to tax. It is established by a level of presence or activity within a state that is sufficient to establish a connection between the state and a business entity that allows the state, under the U.S. Constitution, to exercise jurisdiction over the business and impose a tax.

Nexus is most clearly established if an out-of-state business maintains a physical presence within the state, like a sales, service, or administrative office.

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Nexus requires some degree of presence within the state. The degree of presence necessary to create nexus is a matter often litigated before the courts. Solicitation of orders from outside the state by mail order, telephone, or other electronic media with delivery made by common carrier generally has been ruled to be insufficient to establish nexus. Under virtually identical facts, but with instate delivery of the product made by the business in its own capacity, nexus is established.

In the past, the concept of nexus has focused on a business' physical contacts or presence in the taxing state. This focus may be outmoded and may be shifting to include a less explicit economic standard based on a regular and systematic exploitation of the taxing state's market by a business. As technological developments change the manner in which business is conducted, a company that uses electronic technology (e.g., toll-free telephone numbers, telemarketing, computer services, etc.) may have no less a "presence" in a state than a business that establishes a physical presence. Both businesses are cultivating the state's market and are enjoying the protection and services offered by the state for which the state deserves a return.

The inherent jurisdiction of states to tax is limited by the U.S. Constitution under the Commerce and Due Process Clauses. The Commerce Clause of the U.S. Constitution prohibits the states from inhibiting or placing an undue burden on the free flow of interstate commerce. Income from business activities constituting purely interstate commerce may be taxed by a state provided the tax is not discriminatory and is properly apportioned to a specific local activity. In other words, a state may tax exclusively interstate commerce as long as the tax does not create an effect proscribed by the Commerce Clause.

The Due Process Clause of the Fourteenth Amendment prevents a state from imposing a tax on a person over whom it has no jurisdiction and requires that the person, object, or activity subject to the tax have some relationship to a fixed position within the particular state. There must be some definite link or minimum connection between an activity within the state and the tax. The underlying question is whether the state has provided some service, protection, or facility for which a return in the form of a tax would be equitable and whether the tax imposed is a reasonable means of defraying the costs of state government. The Supreme Court has set a standard of fairness that implies that if a sufficient contact between the taxing state and the nonresident taxpayer exists, and the tax imposed is fairly related to the taxpayer's in-state business activities, the tax will pass constitutional muster. The most frequently cited description of the due process standard is found in a Supreme Court case dealing with the power of a state to impose a tax on a foreign corporation on dividend income derived from property located and business transacted in the state:

> "That test is whether property was taken without due process of law.... whether the taxing power exerted by the state bears fiscal relation to protection, opportunities, and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask for a return."[1]

There is no “bright line” test regarding the circumstances that cause a contact to be sufficient to subject a business to taxation by a state.

[1] *Wisconsin* v. *J.C. Penney Co.* (1940) 311 U.S. 435.

Congress further restricted the states' powers to tax even when Constitutional nexus was established by enacting Public Law (P.L.) 86-272. P.L. 86-272 prohibits states from imposing an income tax upon the income of a person derived within the state if the person's only business activity in the state is "solicitation" of orders for sales of tangible personal property. P.L. 86-272 applies where the orders are sent outside the state for approval and, if approved, are filled and delivered from a stock of goods located outside the state.

California's interpretation of P.L. 86-272 is summarized in the publication, "Application and Interpretation of Public Law 86-272 (FTB Pub. 1050)." The key points of this interpretation are:

1. Under P.L. 86-272, only income derived within the state from the sale of <u>tangible personal property</u> is immune from taxation. This law does not prohibit California from taxing income from selling or providing services and selling, leasing, renting, licensing or other disposition of real estate, other personal property, intangibles, or other types of property in this state.

2. The activity must be limited to <u>solicitation</u> (except as noted under #3).

3. P.L. 86-272 extends to activities performed on behalf of the person by independent contractors that do not represent a single person. Independent contractors may solicit sales, make sales, and maintain a sales office without defeating a person's immunity from income taxation. However, the independent contractor may not maintain a stock of goods on behalf of the person in California.

Under current state law it is unclear whether electricity is considered tangible personal property and thus whether P.L. 86-272 would apply to income derived from a sale of electricity. Department staff does consider electricity to be tangible personal property. However, there has been no authoritative decision on this issue in California.

<u>FEDERAL/STATE LAW</u>

Prior federal law (1980 to 1988) imposed a windfall profits tax on oil. The tax rate ranged from 15% to 70% of the difference between the market price of oil and a predetermined base price.

California has not imposed a state-level windfall profits tax.

Existing state law imposes tax on the income earned by individuals, estates, and trusts. Tax is imposed on the entire taxable income of residents of California and upon the taxable income of nonresidents derived from sources within California. The tax for individuals is computed on a graduated scale at rates ranging from 1% to 9.3%.

Existing state law imposes a franchise tax on every corporation either qualified to do business in this state or doing business in this state (whether organized in-state or out-of-state). The franchise tax is not a tax on income. Rather, it is a tax, measured by net income, for the privilege of doing business within the state. The corporate franchise tax rate is 8.84%. The S corporation franchise tax rate is 1.5%. Taxpayers are subject to a minimum franchise tax of $800 only if it is more than their measured tax.

Existing state law also imposes a corporate income tax on corporations that are not organized in or qualified to do business in California, but are deriving income from California sources. This tax is also 8.84% and 1.5% for S corporations. However, the minimum franchise tax does not apply to corporations subject to the corporate income tax.

THIS BILL

This bill would impose a windfall profits tax on a taxpayer (or an affiliate of the taxpayer) that is a power generator or middleman. The rate of the tax is unspecified.

"Affiliate of the taxpayer" would be defined as a person whose relationship is described in Internal Revenue Code (IRC) 267 or 707(b).

"Power generator" would be defined as a person engaged in business described in Code 22111 of the North American Industry Classification System (NAICS) Manual. NAICS Code 22111 includes establishments primarily engaged in operating electric power generation facilities. These facilities convert other forms of energy, such as waterpower (i.e., hydroelectric), fossil fuels, nuclear power, and solar power, into electrical energy. The establishments in this industry produce electric energy and provide electricity to transmission systems or to electric power distribution systems.

"Middleman" would be defined as a person engaged in the trade or business of buying and selling electrical power produced by a power generator.

"Windfall profits" would mean the portion of gross receipts from the sale of electrical power that is sold for ultimate use in California that exceed an unspecified percentage of:

- the power generator's cost (direct costs as defined in IRC Section 263A) to produce that electricity, or
- the purchase price (contract price) of the electricity established by a middleman.

The windfall profits tax would be imposed and collected in the same manner as the Personal Income Tax and the Corporation Franchise Tax.

IMPLEMENTATION CONSIDERATIONS

This bill would create an additional tax that would be imposed only on a few taxpayers. It is assumed that the windfall profits tax would be assessed and collected through the current income tax or franchise tax forms (e.g., Form 540 and Form 100).

Based on this assumption, significant changes would have to be made to the department's programs and operations to impose this new tax. Staff believes these changes could be accomplished during the normal annual update.

Given the limited number of taxpayers, tax returns containing the windfall profits tax would likely be processed manually. The following implementation concerns have been identified with this bill. The department's staff is available to assist with any amendments to resolve these concerns.

- "Windfall profits" is the gross receipts from sales of electricity to the extent that those receipts exceed an unspecified percentage of costs to produce the electricity. Without clearer definitions of what costs are taken into account, determining the costs to produce electricity could become a highly subjective inquiry that could cause disputes between taxpayers and the department.

- The term "taxpayer" should be defined for the Bank and Corporation Tax Law (B&CTL) windfall profits tax. The term "taxpayer" as defined in the Personal Income Tax Law (PIT) would apply to the windfall profits tax for PIT taxpayers. However, the definition of "taxpayer" under (B&CTL) would not apply to the windfall profits tax for B&CTL taxpayers because that definition applies only to persons subject to the corporate franchise tax, alternative minimum tax, and income tax.

- It is unclear whether corporations required to pay the windfall profits tax would be able to claim a deduction for that tax on their corporate franchise or income tax return. Generally, corporations are not allowed a deduction for a tax on, according to, or measured by income. Based on the current structure of the windfall profits tax, it appears that it would not be deductible. However, without a clear declaration by the statute, there could be disputes between taxpayers and the department regarding whether the windfall profits tax is deductible.

- The definition of "windfall profits" measures gross receipts from selling electrical power "that is sold for ultimate use in California." Once electricity is put onto the transmission grid it may be difficult, if not impossible, to determine where a particular watt is actually used and whether the windfall profits tax applies. This could result in disputes between taxpayers and the department.

- Since the bill specifies that the windfall profits tax would be imposed and collected like the personal income tax and franchise tax, quarterly estimated payments would be required. Taxpayers would already have made estimated payments during 2001 based on their existing tax liability. Thus, taxpayers may owe interest and penalties for failing to pay estimated taxes based on their windfall profits tax liability.

- If a taxpayer underpays its tax liability, the bill does not specify whether the payment should be credited first to the income tax or franchise tax liability, with the remainder to the windfall profits tax, or vice versa, or whether the insufficient payment should be proportionally divided.

LEGISLATIVE HISTORY

SB 1X (Soto, 2001/2002) would impose an Electricity Windfall Profits Tax on sellers of electricity and refund the amount collected to individuals that file a tax return.

SB 14 (Thompson, 1995/1996) and SB 1777 (Burton, 1999/2000) would have imposed a Petroleum Windfall Profits Tax on certain taxpayers engaged in petroleum refining. SB 14 failed passage in the Assembly Revenue and Taxation Committee. SB 1777 was held in the Senate Rules Committee.

OTHER STATES' INFORMATION

Florida, Illinois, Massachusetts, Michigan, Minnesota, and *New York* laws do not have windfall profits taxes.

However, *New York* does impose a privilege tax on natural gas importers for importing or causing to be imported gas services into *New York* for their own use or consumption. This tax is gradually being phased out through rate reductions and will be totally eliminated by January 1, 2005.

The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

FISCAL IMPACT

The department's costs to administer this bill cannot be determined until implementation concerns have been resolved and department staff develops an implementation strategy. Department staff anticipates that the bill may need to be amended to add supplemental appropriations for FTB's fiscal year 2000-01 budget and to appropriate funds for FTB's fiscal year 2001-02 budget to administer this bill.

ECONOMIC IMPACT

The revenue estimate is not possible at this time due to the following:

- Unspecified percentage for the proposed tax.
- Unspecified percentage of gross receipts in excess of cost or the purchase price of electricity in order to calculate the amount subject to the proposed Electrical Power Generation Windfall Profits Tax.

LEGAL IMPACT

Some sellers of electricity that have profited from the California energy crisis may not be impacted by the windfall profits tax because they do not have sufficient nexus in California. Although this bill would attempt to subject such companies to the windfall profits tax, it is unknown whether the tax could withstand constitutional challenge.

The windfall profits tax could be considered a form of indirect price regulation. Electricity price regulation is within the jurisdiction of the Federal Energy Regulatory Commission. As a result, this tax could be viewed as preempted by federal laws or regulations, and thus unconstitutional. However, if the tax rate imposed on the "windfall profit" is less than 100%, there is less likelihood that the tax would seen as a regulatory act, because it would not effectively place a "price cap" on the cost of electricity sold.

As defined by the bill, the windfall profits tax appears to be a tax based on income. If it is considered to be a tax on income and electricity is considered to be tangible personal property, the imposition of the windfall profits tax would be further subject to the limitations contained in P.L. 86-272.

The windfall profits tax applies to taxpayers and affiliates of the taxpayer. As defined by the bill, the taxpayer of a selling affiliate could be in a completely unrelated business. There is no requirement that the businesses be unitary. Imputing affiliate nexus upon a unitary business component is more likely to withstand constitutional challenge than a non-unitary relationship.

ARGUMENTS/POLICY CONCERNS

This bill could be viewed as inequitable as it would impose an additional tax on a single industry that already is subject to state taxation to the extent of any income derived from California sources. On the other hand, this industry has been perceived as excessively driving up the cost of electricity for a profit.

The windfall profits tax would not apply to corporations that do not have nexus in California. Some companies that have profited from the California energy crisis may not be impacted by the windfall profits tax because they do not have sufficient nexus.

The windfall profits tax is imposed upon affiliates of the taxpayer as defined in IRC Section 1504. IRC Section 1504 applies to 80% or more owners and foreign corporations. The windfall profits tax would not apply to 70% affiliates or a generator that is a foreign corporation.

The windfall profits tax could be avoided by generators selling to a "middleman," who in turn resell the electricity for use in the state at a mark up just below the proposed statutory percentage for middlemen.

The bill could also be viewed as inequitable in that only certain recipients of windfall profits are subject to the tax. Taxpayers that sell electrical power produced in co-generation electrical power facility that are not included in NAICS Code 22111 and, as a result, would not be subject to the tax. In addition, taxpayers that buy and sell electrical power but are not engaged in the trade or business of buying and selling that electrical power would not be subject to the windfall profits tax. For example, a manufacturing facility that generates its own power can stop manufacturing for a brief period and sell its electricity during peak price opportunities.

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