

SUMMARY ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Corbett & Wiggins Analyst: Marion Mann DeJong Bill Number: AB 128X

Related Bills: See Prior Analysis Telephone: 845-6979 Amended Date: 05/08/2001

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Excess Gross Receipts from Electrical Energy Distribution Tax

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended _____.

FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO _____.

REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED April 4, 2001, STILL APPLIES.

OTHER - See comments below.

SUMMARY

This bill would:

- impose a tax on excess gross receipts from electrical energy distribution (excess tax), and
- require purchasers of electricity to withhold and remit 100% of the excess tax.

SUMMARY OF AMENDMENT

The May 8, 2001, restructured the windfall profits tax on electrical businesses into the excess tax.

The "Purpose of Bill," "Background," Federal/State Law," Legislative History," and "Other States' Information" discussions in the department's analysis of the bill as introduced April 4, 2001, still apply. Additional information regarding Public Law (P.L.) 86-272 is added to "Background" below. The remainder of the department's analysis of the bill as introduced is replaced with the following.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment. However, the bill specifies that the excess tax would be operative for each calendar quarter beginning on or after January 1, 2001, and before January 1, 2006. The withholding provisions would be operative for the first calendar quarter beginning after the bill becomes effective.

Board Position:

____ S ____ NA ____ NP
____ SA ____ O ____ NAR
____ N ____ OUA PENDING

Legislative Director

Date

Brian Putler

06/12/01

POSITION

Pending.

Summary of Suggested Amendments

Amendments are needed to resolve implementation concerns. See "Implementation Considerations" below. Department staff is available to assist the author with amendments.

BACKGROUND

The background discussion regarding P.L. 86-272 in the prior analysis still applies. However, it should be noted that P.L. 86-272 was amended in 1976 to add a provision regarding electricity. P.L. 86-272 specifically prohibits discriminatory state taxation of out-of-state manufacturers, wholesalers, retailers, or consumers of electricity.

ANALYSIS

THIS BILL

This bill would impose an excess tax on certain sellers of electricity in California. The sellers of electricity must have nexus in California and make the first sale of electrical power for consumption in California. The tax rate would be determined by the amount that the sales price per megawatt hour (MwH) of electricity exceeds the base price, as follows:

If sales price is:	Tax Rate
More than the base price but not more than 150% of the base price	50%
More than 150% of the base price but not more than 200% of the base price	70%
More than 200% of the base price	90%

"Base price" would mean \$60 per MwH of electricity sold, or any subsequent price set by the California Public Utilities Commission (CalPUC). The Franchise Tax Board (FTB) would be required to publish any revised base price. Revised base prices would become effective for the first calendar quarter beginning at least 30 days after FTB publishes the revised base price.

"Sellers of electricity" would mean a person or any other entity, that is a producer, generator, wholesaler, marketer, retailer, marketer, or other vendor of electricity sold for consumption in this state.

"Sold for consumption in this state" would mean any of the following:

- sales of electricity made directly to a purchaser in this state for that purchaser's consumption in this state.
- sales of electricity to a retailer of electricity for resale to a purchaser in this state for that purchaser's consumption in this state.
- sales of electricity to the State of California, to any agency of the state, or to the California Independent Systems Operator (ISO).

“Nexus” would be established if the seller of electricity meets any of the following conditions, which exceed a de minimis level of contact:

- Has a physical presence in California through the presence of one or more employees, agents, members of a commonly controlled group, or representatives or other persons acting on the seller’s behalf, whether or not characterized as an independent contractor.
- Owns, leases, or rents real or tangible property in California.
- Maintains a contractual relationship with persons in California relating to the sale, distribution, or transmission of electricity to purchasers within California.
- Regularly or systematically solicits a market for the sale or purchase of electricity for the ultimate consumption in California or otherwise purposefully avails itself of California’s electricity market.
- Directly or indirectly delivers or causes delivery of electricity to any portion of the electrical grid located within California or otherwise uses that electrical grid.
- Is a member of a unitary group for which at least one member is required to file a combined report or would be required to file if a water’s-edge election were not in place.
- Conducts any other activity that is not otherwise protected under the U.S. or California Constitutions, or federal or California laws.

“Electrical grid” would mean the system of interconnected generators and power lines managed in order to dispatch generators as needed to meet the requirements of the customers connected to the grid.

A seller is required to remit 100% of the excess tax to FTB by the 15th day of the month immediately following the calendar quarter. Interest would be assessed on amounts not remitted by the due date. The seller would also be required to file a quarterly return to FTB by the 15th day of the month immediately following the calendar quarter.

For calendar quarters beginning on or after January 1, 2001, and before the date this bill becomes operative, the tax and the return are due no later than the 15th day of the first month immediately following the calendar quarter in which the bill becomes operative.

Since electricity is fungible, the bill would provide a method for sellers to determine the amount of electricity sold to a retailer that also generates its own electricity for retail. “Sales of electricity to a retailer of electricity for resale to a purchaser in this state” would be determined by multiplying the total sales made to a retailer during the calendar quarter by the greater of the following two ratios:

1. The ratio of retailer’s total sales of electricity made directly to purchasers in California during the 2000 calendar year to the retailer’s total sales of electricity everywhere during the 2000 calendar year. If the retailer had no sales history during the 2000 calendar year, the ratio would be zero.
2. The ratio of retailer’s total sales of electricity made directly to a purchaser in California for that purchaser’s consumption in California during the calendar quarter to the retailer’s total sales of electricity everywhere during the calendar quarter.

Retailers would be required to provide sellers and FTB with the information needed to determine these ratios. If the information needed to determine these ratios were not available, the seller would make a tentative payment based upon the last available information.

Once the retailer's information is available, the difference between the tentative payment and the tax due should be remitted to FTB no later than the 15th day of the first month following the calendar quarter in which the information becomes available.

Except for residential customers and small businesses, all purchasers of electricity for consumption in California would be required to withhold 100% of the excess tax from payments made to sellers. For purposes of determining the withholding amount, the base price would be \$60 per MWh rather than the base price set by the CalPUC.

The tax would be remitted to FTB by the 15th day of the month immediately following the calendar quarter in which the tax was withheld. Every purchaser required to withhold would be liable as a withholding agent for the tax. Interest for failure to pay tax by the due date would be assessed on the taxpayer. The taxpayer is authorized to seek reimbursement for interest paid from the withholding agent obligated to remit the withheld tax. In addition, the withholding agent would be required to file a quarterly statement to FTB showing:

- the seller's name,
- the seller's tax identification number,
- the amount of tax withheld;
- the total number and amount of MWh of electricity purchased,
- the sales price of the electricity purchased,
- the purchaser of the electricity, and
- other information FTB deems necessary.

FTB would be required to inform each seller of electricity for which the excess tax was withheld and remitted to FTB by a purchaser of (1) the amount withheld and remitted, and (2) information related to the ratios for retailers if applicable.

The amount withheld and remitted would be presumed to be the excess tax owed, unless the seller requests a refund. The seller would be required to explain the reasons and facts that demonstrate why the tax withheld and remitted did not accurately reflect the tax owed.

The base price set by the CalPUC would be presumed to represent a fair sales price reflecting the seller's cost of selling electricity plus a reasonable allowance for profit margins and maintenance and operational expenses. The seller could dispute the base price by filing a claim for refund with FTB. The claim must provide the reasons and calculations that demonstrate that the base price does not reflect the taxpayer's actual costs of selling electricity or provide for reasonable profit margins and maintenance and operational expenses.

The seller could also file a claim to dispute the ratios used to determine the amount of electricity sold to a retailer that also generates its own electricity for retail.

The CalPUC would be required to review any claim for refund and make recommendations to FTB regarding disposition of the claim. Claims for refund would be required to be filed within four years from the date the tax was required to be remitted or within one year from the date the tax was remitted, whichever period is longer.

The CalPUC, in consultation with FTB, could authorize exemptions from all or part of the excess tax for sales of electricity derived from renewable energy sources.

IMPLEMENTATION CONCERNS

Since the tax amount would be withheld and remitted quarterly to the department, the excess tax would be administered outside current income tax forms and processes. The department would need to develop new forms, programs, and operations to administer this new tax. Department staff is reviewing the bill and developing a strategy for implementation. However, withholding of taxes is currently a program administered by the Employment Development Department. EDD has ongoing business constituents that comply with employee tax withholding requirements. That department may be able to implement the provisions of this new withholding program quickly.

The following implementation concerns relating to the excess tax have been identified with this bill. Department staff is available to assist with any amendments to resolve these concerns.

- Sellers would be required to remit the excess tax for calendar quarters beginning before the bill becomes operative by the 15th day of the first month immediately following the calendar quarter in which the bill becomes operative. This would require returns to be filed prior to the enactment of the bill. For example, assume the bill was enacted on September 12, 2001. The bill specifies that the excess tax is operative for taxable years beginning on or after January 1, 2001. Thus, the tax and returns for calendar quarters beginning before September 12, 2001, would be due on April 15, 2001. It appears that the author should use “the date the bill is enacted” rather than “operative date.”

However, if the bill were amended to be “the date the bill is enacted,” the deadline could be within 15 days of the enactment date (using the September 12, 2001 date from above the due date would be October 15, 2001). Department staff is concerned that forms and processes could not be developed in time to process the remittance of the excess tax. Further, it may be difficult to provide withholding agents with appropriate instructions for withholding and remitting the tax before the withholding amounts are due.

- The excess tax is imposed on gross receipts from selling electrical power that is consumed in California. Once electricity is put onto the transmission grid it may be difficult to determine where a particular watt is actually used and whether the excess tax applies. It may be difficult for taxpayers, withholding agents, and department staff to determine if a sale is for electricity consumed in California. This could result in disputes between taxpayers and the department.
- The requirement that the seller and withholding agent remit tax at the same time is problematic. Although the seller can reduce the amount they are required to remit by any amounts withheld, sellers may not know what amounts have been withheld, and may overpay the tax. FTB is required to inform sellers of amounts withheld and remitted by withholding agents. However, this information could not be sent to the seller prior to the due date since the withholding agent has the same deadline to remit the tax.
- Department staff would not know when a sale occurred to enforce withholding or collection of the tax.

- The bill requires the tax to be remitted by the 15th day of the month immediately following the calendar quarter in which the sale occurs. The bill does not specify how to treat long-term contracts where a sale occurs but payment is made over a period of time. As drafted, it appears that the tax would be imposed regardless of when payment is received.
- The bill requires every seller to “transmit” a return to FTB (page 5, line 3) in the form and manner prescribed by FTB. Generally, returns are “filed” with FTB. The term “filed” allows paper or electronic filing. The use of the term “transmit” implies that all returns must be sent electronically.
- The bill requires FTB to publish the base price set by CalPUC, however it does not specify how the rate is to be published or for how long.
- It is unclear whether corporations required to pay the excess 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.

TECHNICAL CONSIDERATIONS

The following technical concerns have been identified. Department staff is available to assist the author with amendments to resolve these concerns.

- An unusual phrase is used in the tax rate language on page 2, line 16 to page 3, line 1. The bill says at a rate determined by “reference to the percentage” by which the sales price exceeds the base price instead of “the amount” by which the sales price exceeds the base price.
- The language of the denominators in the retailer ratios is inconsistent. The denominator of the first ratio says “to *the sum of* the retailer’s total sales of electricity everywhere during the 2000 calendar year” (page 3, line 39 to page 4, line 1). The denominator of the second ratio says “to total sales of electricity everywhere during that calendar quarter” (page 4, lines 9 and 10). “The sum of” is not needed in the first denominator.
- On page 5, line 26, the word “the” should be inserted before “act.”

FISCAL IMPACT

The department's costs to administer this bill cannot be completely determined until implementation concerns have been resolved. However, department staff anticipates that the bill would 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. It is estimated that costs would range from \$5.4 million to \$6.1 million.

ECONOMIC IMPACT

Revenue Estimate

Based on limited information and the discussion below, it is estimated that the excess tax could range from hundreds of millions of dollars to as much as \$2 billion in the first year. As explained below, the majority of revenue generated as a result of this bill would primarily affect energy sales that transpire

prior to the enactment of this bill and before market participants could change their trading patterns and behavior as a result of this bill becoming law.

Revenue Discussion

Developing estimates of this sort is very speculative due to inherent uncertainties, such as, limited information regarding the sale of electricity for consumption in California, predicting future sale prices for electricity in California and changes to the base price by the CalPUC. Also the number and dollar amounts of potential refund claims, exemptions authorized, trading patterns, and behavior change of market participants are uncertain.

Industry experts estimate that during the first four months of the year (2001), California paid approximately \$2.5 billion in excess profits for the purchase of electricity. Of this amount, it is unknown how much of the estimated excess profits would be subject to the excess tax. It is staff's understanding that the majority of energy sales made to California were sold through middlemen and not directly from the generators and in some cases electricity was traded over and over again, before finally being sold to California for consumption. Therefore, it is unknown if the final sales price to California represented sellers' cost plus "reasonable profit," which would exclude the seller from the excess tax.

In consulting with market experts who analyze behavior of market participants, it is anticipated that the majority of traders will change their behavior by; 1) charging rates within the base price, 2) be able to fully justify any increase in production cost, which would justify sales in excess of the base price, or 3) restructure their trading patterns so as not to subject themselves to the excess tax.

In summary, it is unknown if this bill would have a significant impact on California's energy prices. However, this bill may change the way business is conducted for market participants in the energy market.

LEGAL IMPACT

Some sellers of electricity that have profited from the California energy crisis may not be impacted by the excess tax because they may not have sufficient nexus in California. Companies that would be subject to the excess tax proposed by this bill may challenge the constitutionality of the nexus provisions contained in this bill. It is unknown whether the tax would withstand such constitutional challenges.

The excess 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, since the tax rate is less than 100%, there is less likelihood that the tax would be seen as a regulatory act, because it would not effectively place a "price cap" on the cost of electricity sold.

The excess tax could be construed to be a net income tax. If it is found to be a tax on net income and if electricity is considered to be tangible personal property, the imposition of the excess tax might be subject to P.L. 86-272. In that case, some sellers of electricity might be immune from tax.

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 an excessive profit.

Although the bill would allow the base price for determining the excess tax amount to increase, the base price for determining withholding amounts is set at \$60. Thus, if the base price increases, the base price used for the withholding requirements would result in over withholding of the excess tax.

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