

ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Koretz and Horton Analyst: Roger Lackey Bill Number: ABX 27

Related Bills: See Legislative History Telephone: 845-3627 Amended Date: 02-07-2001

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Power Generation System Credit/Sales & Use Tax Paid Credit/Depreciation Deduction

SUMMARY

This bill would:

- Allow a credit for a percentage of the cost to purchase or lease and to install a power generation system.
- Allow a credit equal to the sales or use tax paid for the purchase or lease of a power generation system.
- Allow a taxpayer to depreciate a power generation system over five years.
- Allow a taxpayer to claim a refund from the Board of Equalization (BOE) equal to one of the income tax credits, above.

This analysis will address the sales tax refund provision only as it impacts the department. This analysis will not address the bill's provisions in the Public Utilities Code or Water Code as they do not impact the department or state income tax revenue.

SUMMARY OF AMENDMENT

The February 7, 2001, amendment specified that personal income taxpayers must use the power generation system onsite to claim the credit measured by the cost of purchasing or leasing and installing a power generation system.

The February 7 amendment also made changes to the Public Utilities Code and the Water Code provisions.

This is the department's first analysis of the bill.

PURPOSE OF THE BILL

Discussion with the author's staff indicated the purpose of the bill is to reduce the demand on the state's power grid during peak hours.

Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ X PENDING

Department Director

Date

Gerald H. Goldberg

03/08/01

EFFECTIVE/OPERATIVE DATE

This bill, as a bill of a special session, would be effective on the 91st day after adjournment of the special session. This bill specifies the credits and special depreciation sections would be operative for taxable years beginning on or after January 1, 2001, and before January 1, 2006.

POSITION

Pending.

Summary of Suggested Amendments

Department staff is currently working with the author's office to draft amendments to resolve the implementation and technical considerations discussed below.

ANALYSIS

FEDERAL/STATE LAW

Credit Discussion

Federal law currently provides two energy-related credits: an energy investment credit, which is a portion of the investment credit, and a business credit for the production of electricity from certain renewable resources.

The energy investment credit is equal to 10% of the basis of energy property placed in service during the taxable year. Energy property includes equipment that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat. It also includes equipment that produces, distributes, or uses energy derived from geothermal deposits. The equipment also must meet performance and quality standards prescribed by federal regulations.

The business credit provides a tax benefit for the production of electricity from certain renewable resources. It is equal to 1.5 cents multiplied by the kilowatt-hours produced by the taxpayer's qualified energy resource facility. To qualify for the credit, energy is required to be sold by the taxpayer to an unrelated person during the taxable year. Qualified energy resources include wind, closed-loop biomass, and poultry waste.

Former state law provided a credit under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL) equal to 10% of the cost of a solar energy system installed on premises located in California and used for commercial purposes. The credit was available for years beginning on or after January 1, 1990, and before January 1, 1994.

The credit provisions defined "solar energy system" as solar thermal electric and photovoltaic systems, but did not include devices that produced electricity through wind energy or energy conservation measures.

The former solar energy credit is further discussed in "Program Background" below.

Current state law does not provide any type of energy credit.

Depreciation Discussion

Current state and federal laws generally allow taxpayers engaged in a trade or business to deduct all expenses that are considered ordinary and necessary in conducting that trade or business. However, expenses for purchasing property with a useful life in excess of a year must be capitalized and depreciated over the recovery period of the property rather than deducted in the year purchased.

THIS BILL

Power Generation Systems Purchase or Lease Credit

This bill would allow a credit for the costs paid or incurred to purchase or lease and install a power generation system on property located in California for the production of electricity used onsite.

The applicable percentage of the costs subject to the credit would be:

- 30% for any solar energy, wind-driven, or photovoltaic generation system,
- 25% for any power generation system placed in service on or before June 21, 2001, and
- 20% for any other power generation system.

“Power generation system” means devices used for the individual function of producing electricity at the rate of 50 megawatts per day or less. A “power generation system” includes, but is not limited to, any solar energy, wind-driven, fuel cell, microturbine, photovoltaic, and natural gas generation system. “Power generation system” does not include any diesel, oil, or steam generation system.

The taxpayer must meet both of the following requirements to obtain the credit:

1. The power generation system generates at least 80% of the electricity used by the taxpayer for each of the five consecutive taxable years beginning with the first taxable year the system is purchased or leased; and
2. The taxpayer uses the generated electricity during peak load hours.

Failure to meet the two requirements would result in loss of the credit.

A non-corporate taxpayer must meet the additional requirement that the power generation systems generate power only for onsite usage by the taxpayer.

A corporate taxpayer would be allowed to apply any unused tax credit against the tax liability of any member of a commonly controlled group of which the taxpayer is a member.

This bill would allow any excess credit to be carried over and used in the following six taxable years.

Power Generation System Sales and Use Tax Credit

This bill would allow a credit against the income tax or franchise tax equal to the sales or use tax paid or incurred for the purchase or lease of a power generation system on property located in California for the production of electricity. This credit is in lieu of claiming the sales or use tax refund, the power generation system purchase or lease credit, and the five-year depreciation deduction created by this bill.

The term “power generation system” under the power generation system purchase or lease credit would have the same meaning for this credit.

This bill would allow any excess credit to be carried over and used in the following six taxable years.

Power Generation System Depreciation Election

This bill would allow the taxpayer to elect to depreciate the power generation system over five years using the straight-line method of depreciation. This special depreciation would be in lieu of claiming the sales tax refund, the power generation system purchase or lease credit, the power generation system sales or use tax credit, and the other deductions that might otherwise be allowable for a power generation system.

Sales and Use Tax Claim for Refund Election

This bill would allow any person that has paid sales or use tax on the purchase or lease of a power generation system for which a credit is allowable to make an irrevocable election to file a claim for refund with BOE. The claim for refund would be for the amount of the credit that would be otherwise allowed on the taxpayer’s income tax return. If the person elects to file a claim for refund with BOE, the taxpayer cannot claim the equivalent power generation system purchase or lease credit or the sales and use tax credit on its income tax return.

This bill would require that the claim for refund be accompanied by proof of payment of the sales tax to a retailer, including purchase date, description of property purchased or leased, price paid, and amount of tax paid. The claim for refund would also have to include a copy of the income tax return on which the tax liability was assessed for which the in-lieu refund is being claimed.

The BOE would be required to provide the Franchise Tax Board (FTB) with an annual list of taxpayers that claimed a sales or use tax refund and the amount of the refunds.

This bill would establish other administrative provisions for the sales and use tax refund that BOE would handle.

This bill would require BOE and FTB to develop rules or regulations to implement this bill.

IMPLEMENTATION CONSIDERATIONS

It is not clear how it would be determined if a power generation system generates at least 80% of the electricity used by the taxpayer, if the power is generated only for onsite usage of the taxpayer, and if that electricity is being used during peak load hours.

It is also unclear what would occur if a taxpayer experienced problems with a power generation system that was required to be shutdown for an extended period of time. As written, if the taxpayer did not meet the 80% criteria, the taxpayer would not be eligible for the credit. The author may want to consider allowing a taxpayer relief from the recapture of the credit in these circumstances.

The meaning is ambiguous of the phrase "used for . . . producing electricity at the rate of 50 megawatts per day or less." It could be interpreted to mean that all power generation systems that *actually* produce less than 50 megawatts per day, regardless of generation capacity, would qualify. It could also mean that a power generation system eligible for the credit is limited to those power generation systems with a maximum power generation capacity of 50 megawatts per day or less.

The terms "microturbine," "photovoltaic," and "wind-driven" are not defined.

The phrase "peak load hours" is ambiguous. It could be interpreted to mean the peak hours of electrical usage in the state, or it could mean the largest volume of electricity being used by the taxpayer on any given day.

The phrases "installed onsite" and "onsite usage" are unclear.

Ambiguous terms and phrases may lead to disputes with taxpayers and increase the costs to the department to administer these credits. As an example, prior law provided a credit for "solar energy systems." That term was not clearly defined. An appellate court was required to determine whether costs of installing counter and floor tile and windows facing south were eligible for the solar energy credit. In *William Lyon Co. vs. Franchise Tax Board* (1992) 4 Cal App. 4th 267 the court denied the credit because the tile and windows were not a part of a "system," and the windows increased summer cooling costs. The terms and phrases used in this bill should be clearly defined to eliminate similar disputes that might occur.

This bill does not prevent a taxpayer that purchases a power generation system and leases it to another taxpayer in this state from claiming the sales and use tax credit, even if the lessee is essentially paying the costs for the power generation system. The lessee might also be eligible for the credit for the leasing and installation of the power generation system, thus resulting in two tax credits being allowed for the same costs.

Since a taxpayer could purchase or lease and begin installation of a power generation system in the middle of a taxable year, a taxpayer could fail to meet the 80% use requirement for the first taxable year. As a result, the taxpayer would never be able to claim the credit for the purchase or lease and installation of a power generation system.

Also, if the taxpayer does meet the 80% use requirement in the first year and claims the credit, the system must continue to generate 80% of the taxpayer's electricity for five years. Failure to comply with this requirement requires previously claimed credits to be disallowed. The recapture of the credit would be impossible to implement because the statute of limitations for assessing additional tax as a result of disallowing the credit is only four years. Recapture of previously allowed credits, which result in the disallowed credit amounts being added to the "tax" or "net tax" in the year the recapture event occurs, may provide a better alternative.

This bill would require non-corporate taxpayers to use the generated electricity onsite. This bill does not include the same limitation for corporations. As a result, a corporate taxpayer could sell electricity it generates to other businesses. If the author's intent is to require corporate taxpayers to use generated electricity onsite, the bill should specify this requirement.

Public utilities, public agencies, and public entities often offer grant programs to encourage people to use alternative means of power (solar power, wind power, etc.) including the purchase and installation of power generation systems. Generally, the amount of any grant received that assisted a taxpayer in the purchase and installation of an eligible item reduces a credit allowed for the same expense. This bill requires no such reduction of the credit.

A claim for refund with BOE can only be made after the date the taxpayer's income tax return is due. It is unclear what benefit a claim for refund for the sales tax reimbursement would have since the taxpayer can receive the same benefit earlier by claiming the credit on the tax return. Moreover, this provision, which is patterned after the Manufacturers' Investment Credit sales and use tax refund provision, creates possibly unintended estimated tax payment issues for any taxpayer that elects to claim this refund rather than simply apply the credit against their income or franchise tax liability.

The sales and use tax credit does not specifically require that sales or use tax be paid to California. This bill only requires that the power generation system be located in California.

The amount of the claim for refund to the BOE is to be equal to the credit amount that would otherwise be allowed on the taxpayer's income tax return. There are two credits allowed under both laws --- one for sales and use tax paid and another for the costs paid or incurred to purchase or lease and install a power generation system. Without clarification, it's unclear which amount would provide the basis for the refund by the BOE.

The special depreciation deduction provision would be repealed on December 1, 2006. However, it is unclear whether a taxpayer that was still entitled to additional depreciation of their power generation system (for example, a system placed in service in 2003) would use the special depreciation method provided by this bill or would have to change their depreciation method due to expiration of this statute.

Under existing law, credits are only available to the taxpayer that incurred the expense that provided the basis for the credit. This bill allows the credit for the purchase or lease and installation of a power generation system to be used by any member of a commonly controlled group. It's unclear what limitations, if any, would be applicable regarding this distribution of the credit among members of a commonly controlled group. A commonly controlled group is not necessarily the same as a unitary group if the other unitary tests are not satisfied during the year (unity of use and unity of operations).

State law conforms to the federal depreciation rules by reference, except for a few exceptions. However, these exceptions are stated in the same section that conforms to the federal rules. The author may want to consider amending the existing depreciation statute rather than creating a new section that provides no reference to current state and federal depreciation rules.

Technical Consideration

On page 5, line 39, the bill states the power generation system purchase or lease credit is allowed if "both" of the following apply. The February 7, 2001, amendment added a third requirement. As a result, "both" should be amended to "all."

LEGISLATIVE HISTORY

AB 15X (Rod Pacheco, 2001/2002) would allow a 100% credit for the purchase of energy conservation measures that reduce a taxpayer's electricity and natural gas use by 5% from the previous taxable year. SB 17X (Brulte, 2001/2002) would allow a credit for the purchase and installation of a solar energy system for the production of electricity. AB 873 (Takasugi, 1997/1998) would have allowed a credit equal to 40% of the cost of energy conservation measures. The bill also would have allowed a second credit equal to 10% of the cost of a solar energy system installed on premises located in California and used for commercial purposes, subject to certain requirements. The bill failed to pass the Assembly Revenue and Taxation Committee.

PROGRAM BACKGROUND

For taxable years 1990 through 1993, state law allowed a tax credit of 10% of the cost of a solar energy system installed on premises used for commercial purposes that were located in California and owned or leased by the taxpayer. The credit could not be claimed for any solar energy system with a generating capacity in excess of 30 megawatts for any taxable year unless the federal government provided at least a 10% federal credit for that solar energy system.

For 1987-1988 state law allowed a credit of 12% of the cost of commercial solar energy systems installed on commercial premises, cooperatives, apartment buildings, or other similar multiple dwellings, including buildings and any other common areas of a condominium maintained by a homeowners' association.

From 1976-1988 state law allowed the solar energy tax credit for personal and commercial premises. The credit was refundable until 1981 and was significantly modified several times. The credit was allowed as a percentage of the purchase and installation costs of solar energy systems on premises owned by the taxpayer. For 1981 and later years, any unused credit could be carried over to succeeding years.

In 1987, the percentages allowed for the solar energy tax credit were 10% of the eligible costs for single-family dwellings, not to exceed a credit of \$1,000. For commercial property the percentage was 25% of the eligible costs. However, only 15% of the eligible costs were allowed in that year for wind energy systems installed on or after January 1, 1986, and on or before June 30, 1987.

OTHER STATES' INFORMATION

Massachusetts: Currently has an energy credit that is equal to 15% of the net expenditures or \$1,000, whichever is less.

New York: For personal income tax (PIT) only, New York allows a credit for solar generating equipment equal to 25% of certain solar generating expenditures. The credit is capped at \$3,700 per system.

Michigan: Does not allow a credit, but exempts the value of energy conservation devices from the local property tax.

Oregon: Currently has two energy credits: a PIT consumer energy purchases credit, and a corporate tax credit for the costs of energy projects. The consumer energy purchases credit allows various credits ranging from \$50 to \$1,500 for consumer purchases of certain items. The corporate credit for the costs of energy projects is a credit equal to 35% of the incremental costs of the project involving energy conservation and other related projects.

FISCAL IMPACT

This bill would not significantly impact the department's programs and operations.

ECONOMIC IMPACT

Due to ambiguous definitions and other implementation considerations discussed above, it is not possible at this time to develop a comprehensive fiscal analysis of the bill. However, the potential exists for annual revenue losses in the hundreds of millions of dollars. Any power generation system up to 50 megawatts would qualify for the credits or refund. Costs, therefore, would vary considerably. For example, the average cost of a photovoltaic system generating one megawatt per day is estimated to be approximately \$7 million. This yields a tax credit of approximately \$2 million (\$7 million x 30%). Therefore, a 50 megawatt photovoltaic system would generate a tax credit on the order of \$100 million.

ARGUMENTS/POLICY CONCERNS

The tax incentives provided by this bill, i.e., a credit for purchasing or leasing and installing a power generation system, a credit for sales and use tax paid on a power generation system, accelerated depreciation deductions for a power generation system, and a refund to payors of sales or use taxes from the BOE measured by the amount of one of two different income tax credits, are loosely inter-related. However, the incentives should be sufficiently connected to one another to prevent the possibility of a taxpayer claiming multiple incentives for the acquisition and use of a single power generation system.

While the power generation system must be installed on property located in California to be eligible for the purchase or lease credit, the sales and use tax credit and the special depreciation deduction do not contain the same requirement. Moreover the sales and use tax credit doesn't even require that the sales and use tax be collected by California, so that payments to another state would literally qualify if the system was brought into California and installed in this state.

This bill allows the credit for the purchase or lease and installation of a power generation system to be used by any member of a commonly-controlled group, irrespective of whether that group is a unitary group or not. Under existing law, credits are only available to the taxpayer that incurred the expense that provided the basis for the credit. The low-income housing credit is an important exception wherein current law specifically permits a corporation to assign all or a portion of its low-income housing credit to one or more affiliated corporations under limited circumstances (but that provision requires 100% common ownership). However, last year the Governor vetoed legislation that would have allowed the low-income housing credit to be used by taxpayers with no economic responsibility for the expenses that provided the basis for that credit.

Assembly Bill 27X (Koretz and Horton)

Amended February 7, 2001

Page 9

LEGISLATIVE STAFF CONTACT

Roger Lackey
Franchise Tax Board
845-3627

Brian Putler
Franchise Tax Board
845-6333