

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Horton Analyst: Kristina E. North Bill Number: AB 25XX

Related Bills: See Legislative History Telephone: 845-6978 Introduced Date: May 17, 2001

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Energy Conservation Refundable Credit and Energy Conservation Deduction

SUMMARY

This bill would create:

- ◆ A refundable credit for personal income taxpayers who purchase energy efficient residential appliances; and
- ◆ A deduction for all taxpayers that install energy conservation measures in their residences or places of business.

These provisions are discussed separately in this analysis.

This bill also would make changes to the Government Code that do not impact this department, and thus are not discussed in this analysis.

PURPOSE OF THE BILL

According to the author's office, the purpose for this bill is to encourage taxpayers to practice energy conservation in their homes and places of business.

EFFECTIVE/OPERATIVE DATE

The bill would be effective January 1, 2002, but specifies that it would be operative for taxable years beginning on or after January 1, 2001.

POSITION

Pending.

Summary of Suggested Amendments

A substantive amendment requesting an appropriation and a technical amendment correcting a typographical error are provided. Department staff is available to assist with amendments to resolve the other concerns addressed in this analysis.

Board Position:

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

Department Director

Date

Gerald H. Goldberg

07/24/01

ANALYSIS

FEDERAL/STATE LAW

Current federal law provides two energy-related credits: an energy 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. The equipment also must meet performance and quality standards prescribed by federal regulations.

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

Prior federal law allowed a credit equal to 15%, up to a maximum total credit of \$300, for the purpose and installation of energy-saving components in an individual's residence. The qualifying expenditures included such items as:

- ◆ Energy efficient furnace burners and electrical or mechanical furnace ignition systems; and
- ◆ Storm or thermal windows or doors, and caulking or weather-stripping or exterior doors or windows.

A separate federal credit equal to 40% of the costs, up to a maximum total credit of \$4,000, was allowed for tax years 1979 through 1986. That credit was based on the purchase and installation of renewable energy equipment, such as solar energy systems, and wind and geothermal energy equipment. It was required that the renewable energy equipment be installed in an individual's primary residence located in the United States. The equipment must have been new when installed and have had an expected useful life of at least five years.

Prior state law allowed two energy related credits: an energy conservation credit equal to a percentage of the cost of energy measures; and a solar energy credit also equal to a percentage of the cost of the solar energy system.

Current state law does not provide a related credit or deduction.

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, or purchases that add to the value or substantially extend the useful life of property owned by the taxpayer, must be capitalized and depreciated over the recovery period of the property rather than deducted in the year purchased.

THIS BILL

REFUNDABLE ENERGY EFFICIENT RESIDENTIAL APPLIANCE REPLACEMENT CREDIT

Under the Personal Income Tax Law (PITL), **this bill** would allow a credit equal to 25% of the costs paid or incurred, apparently up to a maximum credit amount of \$500, for the purchase of energy efficient residential appliances as replacements for existing appliances.

This bill would define:

- ◆ “Appliances” as including refrigerators, washing machines, clothes dryers, hot water heaters, microwave ovens, convection ovens, dishwashers, space heaters, and portable air-conditioning systems.
- ◆ “Energy efficient” as any appliance certified to meet the applicable *ENERGY STAR* efficiency requirements developed by the U.S. Environmental Protection Agency and the U.S. Department of Energy.

As a condition of claiming this credit, the taxpayer must obtain a signed statement from a particular business representative verifying that the replaced appliance was disposed of properly.

This bill would not allow any other credit or deduction for the purchase of energy efficient residential appliances for which this credit is allowed.

This bill would not allow this credit to a taxpayer who receives a grant, loan, or rebate from the State Energy Resources Conservation and Development Commission or any other state or local agency for the purchase of energy efficient residential appliances for which this credit could be claimed.

Any credit amount that exceeds the taxpayer’s tax liability would be refunded to the taxpayer upon appropriation by the Legislature.

IMPLEMENTATION CONSIDERATIONS

It is unclear how the department would determine if a taxpayer receives a grant, loan, or rebate from the State Energy Resources Conservation and Development Commission, or any other state or local agency.

Clarification is necessary to determine the intent for the \$500 limitation. As written, this bill could be interpreted to limit to \$500 the amount of qualified costs that may be claimed for this credit or limit the maximum allowed credit to \$500.

This bill does not specify if the term “replacement” is intended as temporary or permanent. Further, this bill specifies that no credit “may” be allowed unless the taxpayer is able to verify proper disposal of the appliance replaced by the purchase of the qualified appliance. Without clarification for the term “replacement” *and* the permissive verification provision, this bill may provide an unintended credit and result in disputes between the department and taxpayers. For example, a renter may claim the credit for the purchase of 1) a space heater to temporarily use in place of the existing central heating unit, or 2) a microwave to use in place of the microwave provided by the landlord. In both instances, the renter neither owns nor disposes of the existing appliance. If the author intends to require verification and to enforce a “no credit” prohibition, it would be preferable to replace “may” (which is permissive) with “shall” (which is mandatory).

Direction is necessary to determine the timing of the disallowance of the credit to a taxpayer receiving a grant, loan, or rebate. For example, it is unclear if the author intends that the credit be disallowed if the grant, loan, or rebate is received in a different year than the taxable year in which the credit is claimed. This issue is clearly presented if the grant, loan or rebate is received in a year after the taxable year in which the credit is claimed.

It is unclear if the author intended to deny a credit to a taxpayer when the taxpayer receives a rebate for installing one energy conservation method, but claims this credit for the installation of a different energy conservation measure for which the taxpayer did not receive a grant, loan, or rebate.

A definition for the term "residential" is necessary because energy efficient "residential" appliances may be capable of being used for non-residential purposes. Undefined terms may complicate implementation and administration of this credit.

A significant number of California residents are not required to file a California income tax return due to their income levels. These individuals may file a tax return to obtain the refundable credit, thereby increasing the number of returns received by the department.

This bill would require regular appropriations by the Legislature to pay for the refundable portion of this credit. If sufficient funds were not appropriated to cover all of the refunds due, the department would suspend payment of the refunds until additional funds were appropriated. This delay would result in additional contacts to the department by refund recipients, which would likely increase departmental costs.

Since the proposed credit is refundable, the credit would need to be shown in the payment section on all personal income tax (PIT) returns except the Form 540 2EZ. This would increase PIT return Forms 540, 540NR, 540X, and potentially the Form 540A by one page. Adding a page to these forms would result in a significant impact on department's operations and costs, would slow return processing, and would increase the amount of return storage space. The department may be required to lease additional office and file storage space; however, the department would work within available space to the extent possible.

Additional resources would be necessary to prevent the fraudulent filing of returns for the purpose of claiming the refundable credit.

TECHNICAL CONSIDERATIONS

Amendment 1 is provided to correct a typographical error.

POLICY CONCERNS

This bill would deny a credit to a taxpayer receiving a grant, loan, or rebate from a state or local agency, but would allow the credit to a taxpayer who receives such a payment from a utility or other private company. This could be interpreted as disparate treatment. However, disallowance of a credit to a taxpayer receiving a grant, loan or rebate from a utility or other private company could lead to implementation concerns because it may be difficult to clearly describe the nature of or to verify whether a taxpayer has received such a grant, loan, or rebate.

The credit provision in this bill does not specify a repeal date. Credits typically are enacted with a repeal date to allow the Legislature to review the effectiveness of the credit.

Historically, refundable credits such as the prior state renter's credit and the federal Earned Income Credit have had significant problems with invalid and fraudulent returns. These problems are aggravated if a refund made to a taxpayer is later determined to be fraudulent because the refund generally cannot be recovered.

This credit would allow non-corporate landlords to claim the credit for a rental unit in which an energy efficient residential appliance was purchased as a replacement for an existing appliance. This credit is not provided in the Bank and Corporation Tax Law (B&CTL), thus it would not be extended to corporate landlords.

This credit does not ensure the benefit is for California by requiring the new appliance to be installed or used in California.

ENERGY CONSERVATION DEDUCTION

Under the PITL and the B&CTL, this bill would allow a deduction of up to \$5,000 for the installation of energy conservation measures in a taxpayer's residence or place of business.

Under the PITL, the deduction must be computed by reducing the maximum allowable deduction by the dollar amount determined by multiplying the taxpayer's adjusted gross income (AGI) by 2%. Under the B&CTL, this computation would be done using the taxpayer's net income rather than AGI.

This bill would define "installed" and "energy conservation measures." The PITL definition for "energy conservation measures" would include whole house fans but the B&CTL definition would not.

The deduction must be claimed for the taxable year in which the energy conservation measure is fully installed, i.e., in a functionally operative state. The deduction may include costs in any prior taxable year related to the installation of the energy conservation measure.

This bill would not allow this deduction to a taxpayer that receives a grant, loan, or rebate from the State Energy Resources Conservation and Development Commission or any other state or local agency for the purchase of energy efficient residential appliances for which this credit could be claimed.

Any credit or depreciation otherwise allowed for costs paid or incurred for which this deduction is allowed must be reduced by the amount of the deduction.

IMPLEMENTATION CONSIDERATIONS

It is unclear how the department would determine if a taxpayer receives a grant, loan, or rebate from the State Energy Resources Conservation and Development Commission, or any other state, local agency.

This bill is internally inconsistent as it disallows a deduction to a taxpayer receiving certain grants, loans, or rebates for the *purchase* of energy efficient residential *appliances*; however, the deduction is for the *installation* of energy *conservation measures*. Clarification of the author's intent is necessary.

It is unclear if the author intended to deny a credit to a taxpayer when the taxpayer receives a rebate for installing one energy conservation method, but claims this credit for the installation of a different energy conservation measure for which the taxpayer did not receive a grant, loan, or rebate.

A taxpayer could install more than one energy conservation measure in a given taxable year.

Clarification is necessary to determine if the author's intent is to deny a deduction to a taxpayer who receives a rebate for installing one energy conservation method (i.e., exterior storm door) when the taxpayer is claiming this deduction for the installation of a different energy conservation measure (air conditioner) for which the taxpayer did not receive a grant, loan, or rebate.

To prevent misunderstandings between taxpayers and the department, it would be helpful if the bill could provide an example of an "Energy Management System to reduce peak lighting and HVAC loads." It would be preferable if the full name of the acronym HVAC could be specifically spelled out in the statute.

Under the PITL, this bill would require the deduction to be reduced by 2% of California AGI.

Individuals who itemize deductions are already reducing certain expenses by 7.5% or 2% of federal AGI. This bill would add a third calculation, complicating the preparation of the income tax return.

Currently, a business can deduct the full amount of many of the smaller items specified as part of this deduction. This bill would prevent any further deduction of the full amount of these smaller items (such as ceiling, wall, and floor insulation, weather-stripping of doors and windows, external hot water insulation or blankets, etc.) under the general business expense deduction by specifically including them in this deduction. Instead, the taxpayer would receive only a percentage of what could otherwise be claimed. Thus, this bill may not be as beneficial to businesses as the current general business expense deduction for claiming the smaller items listed under the energy conservation measures definition.

This bill requires that any credit or depreciation otherwise allowed for which this deduction is allowed must be reduced by the amount of the deduction. However, the manner by which "depreciation otherwise allowed" is to be reduced by the amount of the deduction allowed by the bill is open to interpretation. One interpretation would reduce the basis subject to depreciation by the amount of the deduction. Another interpretation would reduce an otherwise allowable depreciation deduction by the amount of the deduction allowed by the bill.

The term "place of business" is not defined and is open to interpretation. For example, a lessee at a mall may be encouraged to make repairs on the location he or she is leasing and claim expenses the landlord would normally incur and claim.

POLICY CONCERNS

This bill would only allow a deduction to a taxpayer that installs energy conservation measures in response to recommendations made by a utility company or energy conservation rater. This bill would not allow a deduction to a taxpayer that voluntarily installs energy conservation measures. This treatment may be viewed as inequitable.

This bill would deny a deduction to a taxpayer receiving a grant, loan, or rebate from a state or local agency, but would allow the deduction to a taxpayer who receives such a payment from a utility or other private company. This could be interpreted as disparate treatment. However, disallowance of a deduction to a taxpayer receiving a grant, loan or rebate could lead to implementation concerns because it may be difficult to clearly describe the nature of or to verify whether a taxpayer has received such a grant, loan, or rebate.

This bill does not ensure a benefit to California by limiting the deduction for installations made in California.

LEGISLATIVE HISTORY

ABX 133 (Horton, 2001/2002) was and **AB 654** (Horton, 2001/2002) is nearly identical to this bill. **ABX 133** died when the first extraordinary session terminated. **AB 654** is in the Assembly Revenue and Taxation Committee.

SB 654 (Haynes, 2001/2002), and **SBXX 54** (Haynes, 2001/2002) would and **SBX 54** (Haynes, 2001/2002) would have allowed a refundable credit for energy conservation. **SB 654** and **SBX 54** failed passage from the Senate Energy, Utilities and Communications Committee. **SBXX 54** is in the Senate Environmental Quality Committee.

ABX 27 (Koretz, 2001/2002) and **AB 1124** (Koretz, 2001/2002) would have and **ABXX 29** (Koretz, 2001/2002) would allow multiple credits and an accelerated depreciation deduction for the purchase of a power generation system. **ABX 27** failed passage from the Assembly Appropriations Committee, and **AB 1124** failed passage from the Assembly Utilities and Commerce Committee. **ABXX 29** is in Assembly Appropriations.

ABX 15 (Rod Pacheco, 2001/2002) would have allowed 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. This bill died when the first extraordinary session terminated but was reintroduced as **ABXX 15**, which is in the Assembly Revenue and Taxation Committee.

ABX 86 would have allowed and **AB 1264** (Campbell, 2001/2002) would allow a 75% credit for the purchase and installation of a solar energy system for residential purposes. **ABX 86** died when the first extraordinary session terminated. **AB 1264** is in the Assembly Revenue and Taxation Committee.

SBX 17 (Brulte, 2001/2002) would have allowed a credit for the purchase and installation of a solar energy system for the production of electricity. This bill died when the first extraordinary session terminated but was reintroduced as **SBXX 17**, which is in the Assembly Revenue and Taxation Committee.

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.

OTHER STATES' INFORMATION

The laws of these states were examined due to similarities in population and business activity with California.

Florida exempts from sales and use taxes certain energy-related activities, such as the manufacturer of or the machinery or equipment used to produce electrical or steam energy. Solar energy systems and components of solar energy systems are tax-exempt through June 30, 2002.

Massachusetts currently has an energy credit that is equal to 15% of the net expenditures or \$1,000 whichever is less. However, Massachusetts does not allow an energy-related deduction, but exempts a limited portion of local property tax for certain alternative energy systems, such as solar or wind powered systems or hydropower facilities built after 1978.

Michigan does not allow an energy-related credit or deduction, but exempts the value of energy conservation devices from the local property tax.

New York allows, for personal income taxpayers only, a credit for solar generating equipment equal to 25% of certain solar generating expenditures. The credit is capped at \$3,700 per system. New York also exempts from property tax for 15 years any increase in assessed value of real property due to the value of a solar or wind energy system approved by the New York State Energy Research and Development Authority.

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.

Texas does not allow an energy-related credit or deduction, but exempts from sales or use tax the repair, remodeling, maintenance, or restoration services on intangible personal property used to conserve energy.

FISCAL IMPACT

Departmental costs to implement the new refundable credit portion of this bill are estimated to be \$5.5 million for initial implementation, with continuing annual costs of \$4.3 million. These costs are based on a projected universe of 2 million new filers and 14 million current filers claiming the credit.

Amendment 2 is provided to request an appropriation for these increased costs.

ECONOMIC IMPACT

Tax Revenue Estimate

Based on data and assumptions discussed below, this bill would have the following order of magnitude revenue losses.

Estimated Revenue Impact of AB 25XX Annual Order of Magnitude As Introduced May 17, 2001 [\$ In Millions]	
	2001/2002 and Ongoing
Refundable Tax Credit	-\$75
Deduction	-\$12

For the refundable tax credit, the estimate assumes an appropriation by the Legislature.

Tax Revenue Discussion

For the proposed refundable tax credit of 25%, the revenue impact would be determined by costs incurred for qualifying residential appliances and the amount of credits generated by taxpayers. This estimate assumes that the Legislature will make an appropriation in the amount necessary to provide refunds to taxpayers.

There are roughly 12.2 million residential structures/units in California. Examples of specified energy efficient residential appliances can range in cost from a low of \$40-\$50 for a portable space heater up to \$1,000 or more for a refrigerator. If one in 20 taxpayers who own or occupy the approximately 12 million residential structures/units incur qualifying costs of \$500, on average, credits generated would total \$75 million.

For the proposed deduction, the revenue impact would be determined by costs incurred for installing energy conservation measures by taxpayers and the adjusted gross income or net income of each of these same taxpayers. The proposed deduction is reduced by 2% of adjusted gross income under the PITL and 2% of net income under the B&CTL. Potential deductions are eliminated once adjusted gross income or net income is \$250,000 or more.

In addition to the 12.2 million residential structures/units, there are over a million business enterprises in California. Specified energy conservation measures and costs that may be claimed as deductions by taxpayers can range in cost from a few dollars for weather stripping to several thousand dollars for a new energy-efficient central heating and air conditioning system in a home to hundreds of thousands of dollars or more by a business in a commercial facility. In any given year, if 1% of households and 5% of businesses incur average costs of \$2,500 and \$5,000 respectively, the potential state revenue loss would be \$10 million for households and \$2 million for businesses assuming an 8% tax rate and allowing for current law business deductions.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 25XX
As Introduced May 17, 2001

AMENDMENT 1

On page 3, line 38, delete "Unites States" and insert:

United States

AMENDMENT 2

On page 7, line 9, insert:

SEC. 5. (a) There is hereby appropriated from the General Fund for expenditure in the 2001-2002 fiscal year the sum of five million five hundred thousand dollars (\$5,500,000) for allocation to the Franchise Tax Board in augmentation of Item 1730-001-0001 of the Budget Act of 2001.

(b) Any funds that are allocated pursuant to subdivision (a) shall be expended by the Franchise Tax Board solely for the purposes of implementation and administration of the Refundable Energy Conservation Credit under Section 17052.88 of the Revenue and Taxation Code.

SEC. 6