**Franchise Tax Board**

# SUMMARY ANALYSIS OF AMENDED BILL

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| Author: | Corbett | Analyst: | Marion Mann DeJong | Bill Number: | AB 2xx |
| Related Bills: | See Prior Analysis | Telephone: | 845-6979 | Amended Date: | 06/12/2001 |
| | | Attorney: | Patrick Kusiak | Sponsor: | |

**SUBJECT**: Excess Gross Receipts from Electrical Energy Distribution Tax/Tax Paid in Another State Credit

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|---|---|
| ____ | 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 ________________________. |
| X | FURTHER AMENDMENTS NECESSARY. |
| ____ | DEPARTMENT POSITION CHANGED TO ________________________. |
| X | REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED May 15, 2001, STILL APPLIES. |
| ____ | OTHER - See comments below. |

## SUMMARY

This bill would:

- impose a tax on excess gross receipts from electrical energy distribution (excess tax),
- require purchasers of electricity to withhold and remit 100% of the excess tax, and
- allow a credit for taxes similar to the excess tax paid to another state.

## SUMMARY OF AMENDMENTS

The June 12, 2001, amendments made the following changes:

- created a credit for taxes similar to the excess tax paid to another state,
- specified that the excess tax would not apply to sales of electricity made pursuant to certain contracts,
- modified how and when the base price would be revised (this resolved the department's implementation concern regarding publishing the base price),
- specified that the ratios used for determining the tax for retailers would be calculated based upon the number of megawatt hours (mWh) sold,
- specified that taxpayers would "file" rather than "transmit" returns to FTB (this resolved the department's implementation concern regarding the "requirement" rather than the "option" of electronic filing),

| Board Position: | | | Legislative Director | Date |
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| ____ SA | ____ O | ____ NAR | Brian Putler | 06/28/01 |
| ____ N | ____ OUA | X PENDING | | |

- clarified the due date for remitting the excess tax and filing returns for calendar quarters beginning on or after January 1, 2001, and before the bill is enacted (this partially resolved the department's implementation concern regarding the due date),
- modified the base price for withholding purposes (this resolved the policy concern regarding this issue contained in the department's prior analysis), and
- made minor technical changes (this resolved the technical concerns contained in the department's prior analysis).

The June 12, 2001, amendments resolved some of the concerns raised in the department's analysis of the bill as introduced May 15, 2001. The "This Bill," "Implementation Concerns," "Technical Considerations," "Legal Impact," and "Arguments/Policy Concerns" discussions from the department's prior analysis have been updated to reflect the June 12, 2001, amendments and are provided below. A discussion of credits for taxes paid is added to "Federal/State Law." In addition, the "Position" is provided below for convenience. The remainder of the department's analysis of the bill as introduced May 15, 2001, still applies.

**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.

**ANALYSIS**

FEDERAL/STATE LAW

Under current federal law, U.S. taxpayers are allowed either a deduction or a tax credit for any taxes paid to a foreign country on their foreign source income.

Current state law allows personal income tax taxpayers a credit for net income taxes paid to another state or U.S. possession on income also taxed by California.

THIS BILL

**Excess Tax**

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 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). Beginning with the first calendar quarter following the effective date of this bill, the CalPUC would revise the base price. The revised base price would apply to the succeeding calendar quarter. The CalPUC must publish the base price by the first day of the last month of each calendar quarter. For example, if the bill became effective September 30, 2001, the CalPUC would be required to publish the revised base price by December 1, 2001. The revised base price would apply to the calendar quarter beginning January 1, 2002, and ending March 31, 2002.

"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.

The excess tax would not apply to sales of electricity for consumption in California made pursuant to a binding written contract executed on or before the effective date of the bill. In addition, the excess tax would not apply to sales of electricity made pursuant to a "qualified contract" executed after the effective date of the bill. A "qualified contract" would mean a binding written contract between a seller and the State of California, or its representative agency. Such contracts must be for more than one year and the State of California, or its representative agency, must determine that the rates established under the contract are reasonable.

A seller is required to remit 100% of the excess tax to FTB by the 15th day of the month immediately following the end of a 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 end of a calendar quarter.

For calendar quarters beginning on or after January 1, 2001, and before the date this bill becomes effective, 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 effective. For example, if the bill were enacted on September 30, 2001, the tax and returns would be due October 15, 2001.

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, based on mWh, 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. The tax would be remitted to FTB by the 15th day of the month immediately following the end of the calendar quarter for 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.

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.

**Credit for Gross Receipts Tax Paid to Other States**

This bill would allow a credit equal to the amount of excess gross receipts taxes legally imposed and paid to another state or political subdivision with respect to the sale of electricity for consumption in California. The amount of the credit could not exceed the taxpayer's California excess tax liability. If the credit were less the amount of excess tax due, the seller would be liable for the remaining amount of excess tax. It is department staff's understanding that currently no state imposes an excess gross receipts tax on the sale of electricity. Thus, this credit would be available only if another state enacted an excess gross receipts tax.

## IMPLEMENTATION CONSIDERATIONS

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 effective by the $15^{th}$ day of the first month immediately following the calendar quarter in which the bill becomes effective. This deadline could require returns to be filed within 15 days of the enactment date. 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.

- The bill provides an exemption from the excess tax for sales of electricity made pursuant to a binding written contract executed on or before the effective date of the bill. Department staff does not know how the electric industry enters into agreements to sell electricity. However, if all sales are made by a written document, it could be argued that no sale made prior to the effective date of the bill and no sale of electricity after the effective date of the bill pursuant to a binding written contract executed on or before the effective date of the bill would be subject to the excess tax. According to the author's staff, the intent was to exempt only sales of electricity pursuant to long-term written contracts executed prior to the effective date of the bill. The bill should be amended to clearly reflect the author's intent regarding binding contracts. Amending the bill would help reduce disputes between taxpayers and the department regarding whether a sale was exempt from the excess tax. It should be further noted that if most sales made prior to the effective date of the bill were exempted from the excess tax, the estimated revenue impact would significantly change.

- 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 would provide a credit for excess gross receipts taxes paid to other states with respect to the sale of electricity for consumption in this state. However, it is unclear what would constitute an “excess gross receipts tax” for purposes of the credit and whether the tax must be described as being “for consumption,” in the same manner as the tax to be added by this bill. For example, if Oregon imposes a tax on generation based on the difference between a sales price and some base price amount, would the credit be denied because the Oregon tax wasn’t an excess gross receipts tax and wasn’t described as imposed on “consumption?” Further, since the bill states the tax must be for the “sale of electricity for consumption in this state,” it appears that the tax imposed by the other state must be on sales of electricity for consumption in California to qualify for the credit.

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 3, lines 5 and 6. 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.

- On page 4, line 3, “base rate” should be replaced with “base price” for consistency.

- On page 5, line 30, “in this state” should be inserted after “activity.”

- On page 6, line 6, “transmitted” should be replaced with “filed” for consistency.

- On page 6, line 14, “filed and” should be inserted before “remitted,” because tax returns are filed not remitted. Taxes are remitted.

- On page 10, lines 5 and 12 should be modified so that they are consistent.

- On page 10, line 22, “is longer” should be replaced with “expires later.”

- On page 10, line 27, “thereof” should be inserted after “political subdivision” to clarify that it is a political subdivisions of the United States.

**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. They may further challenge the constitutionality of the exemption provision for qualified contracts between sellers and the State of California on the basis of equal protection. 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.

Because of the exemption from the excess tax for “qualified contracts,” contracts for the same period and the same price could be taxed differently when the buyer is a municipal utility district or electricity company instead of the State of California.

With the credit for gross receipts tax paid to other states, California will always yield its right to tax to another state that has a similar tax, even though the electrical energy is in fact consumed in California. The credit is apparently designed to avoid double taxation on essentially the same transaction. It could be argued that given that California consumers are actually paying the high price for electricity if a credit to prevent double taxation is to be allowed, the state of generation should provide that credit, because consumers in the state of generation are not harmed by the excess prices. Alternatively, the potential tax revenue from the sale transaction could be equally divided between the state of consumption and the state of generation.

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