

**SUMMARY ANALYSIS OF AMENDED BILL**

Author: Soto & Scott Analyst: Marion Mann DeJong Bill Number: SB 1xx

Related Bills: See Prior Analysis Telephone: 845-6979 Amended Date: 8/27, 9/4 & 9/6/01

Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Electric Windfall Profits Tax/Electricity Consumers Refundable Credit

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 amended August 20, 2001.

FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO \_\_\_\_\_.

REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED May 17, 2001, STILL APPLIES.

OTHER - See comments below.

**SUMMARY**

This bill would:

- \* impose a windfall profits tax on sellers of electricity, and
- \* refund the windfall profits tax to individuals who file an income tax return for the previous year.

**SUMMARY OF AMENDMENTS**

The August 27, 2001, amendments made the following changes:

- \* Modified the operative date so the bill would be operative for taxable years beginning on or after January 1, 2001.
- \* Modified the credit so that any individual that files an income tax return rather than an individual "required to file" a return qualifies for the credit.
- \* Modified the definition of "sellers of electricity."
- \* Provided definitions for the terms used to define "sellers of electricity."
- \* Removed the requirements that sellers of electricity self remit the windfall profits tax and file a monthly return.
- \* Modified the exemption from the windfall profits tax for generators of renewable energy sources and cogeneration and made additional sales exempt from the tax.
- \* Modified the annual reporting requirement to the Legislature.

Board Position:

_____ S	_____ NA	_____ NP
_____ SA	<input checked="" type="checkbox"/> O	_____ NAR
_____ N	_____ OUA	_____ PENDING

Legislative Director	Date
<b>Brian Putler</b>	<b>09/13/01</b>

The September 4, 2001, amendments made the following changes:

- \* Further modified the credit so that any individual that filed an income tax return for the preceding taxable year rather than the current taxable year qualifies for the credit.
- \* Added an exemption from the windfall profits tax for self-generation electrical units.
- \* Further modified the annual reporting requirement to the Legislature.
- \* Made a department recommended technical change.

The September 6, 2001, amendments made the following changes:

- \* Revised the authority to deduct refunds of the windfall profits tax from amounts available for the credit.
- \* Added an exemption to the withholding requirements for companies regulated by the Public Utility Commission of Nevada.
- \* Made a minor technical change.

These amendments resolved some of the department's implementation concerns, resolved all the technical concerns, and raised new concerns. The "Effective/Operative Date," "This Bill," "Implementation Concerns," and "Fiscal Impact" discussions from the prior analysis have been updated to reflect the amendments. In addition, the "Position," "Economic Impact," "Legal Impact," and "Arguments/Policy Concerns" discussions are provided below for convenience.

The "Purpose of the Bill," "Background," "Federal/State Law," "Legislative History," and "Other States' Information" discussion from the department's analysis of the bill as introduced May 17, 2001, still apply.

## **EFFECTIVE/OPERATIVE DATE**

As a tax levy, this bill would become effective immediately upon enactment. However, the bill specifies that it would apply to taxable years beginning on or after January 1, 2001.

## **POSITION**

Oppose.

At its June 27, 2001, meeting, the Franchise Tax Board voted 2-0 to oppose this bill as amended May 17, 2001, with Annette Porini, on behalf of Member B. Timothy Gage, abstaining.

## **Summary of Suggested Amendments**

Amendments are needed before this bill can be administered. See "Implementation Considerations" below. Department staff is available to assist the author with amendments.

THIS BILL

*Windfall Profits Tax*

This bill would impose a windfall profits tax on sellers of electricity. The windfall profits tax would be equal to 100% of the amount by which the sales price of electricity sold in this state exceeds the base price. The windfall profits tax would apply only to transactions of wholesale electricity that are the last transactions prior to supplying the electricity at retail to California customers, not every transaction in the distribution chain. In addition, the tax would not apply to sales of electricity made pursuant to a binding written contract executed on or before the effective date of the bill, or made by any of the following:

- \* a California-based local publicly owned electric utility, provided its governing board determines the sales price to be just and reasonable,
- \* generators of renewable energy sources,
- \* generation units installed, operated, or maintained at a generation facility site exclusively to service the electrical load of that facility, or
- \* qualifying small power production facilities or qualifying cogeneration facilities.

The California Public Utilities Commission (CPUC) would be required to notify FTB of all “obligations” of sellers under the windfall profits tax.

Corporations required to pay the windfall profits tax could not claim a deduction for that tax on their corporate franchise or income tax return.

“Base price” would mean the price developed and approved by the CPUC on a plant-by-plant basis that is equivalent to the cost based rates. The “cost based rates” would mean the cost of producing electricity as adjusted for a reasonable allowance for profit margins and maintenance and operating expenses. “Reasonable allowance for profit margins and maintenance and operating expenses” would mean an amount up to a 20% return on invested capital or other rate of return on invested capital as determined by the CPUC.

The bill would grant specific authority to the CPUC to inspect the books and records of sellers to determine the base price and fulfill the purpose of the windfall profits tax. The CPUC could reevaluate the base prices as necessary. In addition, a taxpayer could submit a written application to the CPUC requesting a reevaluation of the base price. The CPUC would be required to respond to the request within 60 days.

“Sellers of electricity” would include any entity, regardless of classification, that is an exempt wholesaler generator, marketer, broker, or other aggregator of electricity, as defined.

The California Independent Systems Operator (CA-ISO), any utility distribution company except a distribution company that is regulated by the Public Utility Commission of Nevada, or any other person or entity in this state that processes or is required to process sales of electricity would be required to withhold 100% of the windfall profits tax from payments made to sellers. The tax would be remitted to the Franchise Tax Board (FTB) by the 15<sup>th</sup> day of the month following the month the tax is withheld. Every withholding entity would itself be liable for the windfall profits tax.

Interest and the penalty for failure to pay tax by the due date would be assessed on amounts withheld and not remitted on or before the due date. In addition, the withholding entity would be required to file a monthly return to FTB showing:

- \* the seller's name,
- \* the seller's tax identification number,
- \* the total number of megawatt hours of electricity sold that was subject to the windfall profits tax,
- \* the total amount of kilowatt hours of electricity sold,
- \* the purchaser of the electricity, and
- \* other information FTB deems necessary.

Penalties for failure to file a return by the due date would be assessed if the withholding entity did not file the monthly return with FTB by the due date .

The amount withheld and remitted would be presumed to be the windfall profits tax owed, unless the seller requested a refund. The seller must 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 CPUC would be presumed to reflect the taxpayer's cost of selling electricity. The taxpayer could dispute the base price by filing a claim for refund providing the reasons and calculations that demonstrate that the base price does not reflect the taxpayer's actual costs of selling electricity.

Claims for refund filed on the grounds that base price fails to reflect the taxpayer's actual costs of selling electricity would be reviewed by the CPUC and no refund would be issued unless the CPUC determines that the taxpayer demonstrates that an adjustment should be made to the base price. The refund amount, if any, would be calculated and approved by the PUC. Claims for refund would 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. Interest would be allowed on any amounts refunded from the date of the overpayment of tax to the date the refund is issued. The interest rate would be the same rate used for income tax purposes. If the CPUC denies a claim for refund, the taxpayer may file a suit for refund in Superior Court according to the procedures for filing a suit for refund under the income tax laws.

The bill specifies that FTB shall administer the windfall profits tax according to its authority under the Administration of Franchise and Income Tax Laws and Regulations. The bill also specifically expands FTB's statutory lien authority for collection of unpaid franchise and income taxes to include unpaid windfall profits tax.

This bill would require the FTB and CPUC to report annually to the Legislature regarding implementation, administration, and compliance with the windfall profits tax.

### *Electricity Consumers Refundable Credit*

Any windfall profits tax due and payable, less any windfall profits tax refunds allowed to windfall profits taxpayers for any prior taxable year, would be distributed in equal amounts, via a tax credit, to individuals who filed an income tax return for the preceding taxable year. Credit amounts in excess of a taxpayer's tax liability would be applied first against any other amounts due from the taxpayer, and then refunded. FTB would determine the amount of the credit. The credit amount would be unknown until the total windfall profits taxes due and payable were determined for the taxable year and were no longer disputed.

The bill would require FTB to report annually to the Legislature regarding implementation of the credit.

### IMPLEMENTATION CONCERNS

#### *Windfall Profits Tax*

Since the total tax amount would be withheld and remitted monthly to the department, the windfall profits 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 quickly implement the provisions of this new withholding program.

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

- \* The windfall profits tax would be effective immediately upon enactment and would be operative for taxable years beginning on or after January 1, 2001. Withholding amounts would be required to be remitted within 45 days from that operative date. Department staff is concerned that forms and processes could not be developed in time to process the remittance of the windfall profits tax.

In addition, since a number of transactions that would be subject to the windfall profits tax would have occurred prior to the effective date of this bill, it would be impossible for any withholding to have occurred. As a result, it's unclear how the windfall profits tax would be assessed on those prior transactions. Since withholding entities are liable for the windfall profits tax, it appears that the withholding entities may be liable for the tax on sales made from January 1, 2001, to the date of enactment, regardless of whether the tax was withheld from the sales price.

- \* The bill contains several undefined terms. Undefined terms can lead to disputes between taxpayers and the department. Definitions should be provided for the following terms:
  - \* "Sales of electricity sold in this state." The windfall profits tax is based on the "sales price of electricity sold in this state." Although the bill specifies that the windfall profits tax only applies to the final sale prior to distribution to retail customers, this definition is overly broad and could be disputed. In addition, the bill does not address whether a sale of electricity is considered to be "in this state" if the seller is not certain where the electricity will ultimately be used.

- \* “Utility distribution company” and “person or entity in this state that process or is required to process sales of electricity.” These terms describe entities required to withhold the windfall profits tax. It is unclear how someone “required to process a sale” that does not “process the sale” would withhold the tax. Further, it is unclear whether the State of California would have an obligation to withhold the tax. Department staff understands that the Department of Water Resources is a major purchaser of electricity.
- \* The bill provides a presumption that the tax required to be withheld and remitted is the full amount of any windfall profits tax owed by the seller (page 8, lines 12 through 15 of the bill). The bill does not specify if the presumption is rebuttable. Further, it is unclear how the presumption applies if a taxpayer argues that the tax should not apply because there is not sufficient nexus to tax. Since the bill provides a claim process where the taxpayer can dispute the tax, the purpose of the presumption is unclear.
- \* It may be difficult for taxpayers, persons required to withhold the tax, and department staff to determine if a sale is for “electricity sold in this state.”
- \* Department staff would not know when a sale occurred to enforce withholding or collection of the tax. It appears that the requirement that the CPUC notify FTB of all “obligations” of sellers is intended to resolve this concern. However, “obligations” is a broad term and may not result in the CPUC providing the department with all the information necessary for enforcement or collection purposes.
- \* The bill specifies that the person required to withhold the windfall profits tax is liable for the tax. This would make the person withholding the tax rather than the seller liable for the windfall profits tax. The bill should be amended to specify that a person required to withhold the tax would be liable if the tax was not withheld as required or was withheld but not remitted to FTB.
- \* The bill provides a method for sellers to dispute the tax amount, the amount withheld and remitted, and the base price. The bill requires the seller to file a claim for refund, but does not specify the procedure for filing the claim or whether to file the claim with FTB or CPUC. Since the bill specifies that the CPUC review the claim, it appears that such claims would be filed with the CPUC.

#### *Electricity Consumers Refundable Credit*

Department staff anticipates that the credit would be administered outside current income tax forms and processes. The department would need to develop new processes to administer this refundable credit. Since the bill would allow the credit to all individuals who filed an income tax return for the preceding taxable year, individuals who are currently not required to file a return could file in future years only to be eligible for the credit. Processing these additional returns would significantly impact the department’s return processing program and departmental costs.

The following implementation concerns relating to the credit have been identified with this bill. The department's staff is available to assist with any amendments to resolve these concerns.

- \* The number of income tax returns filed for the preceding taxable year is needed to determine the credit amount. Since the bill does not specify a date that the preceding year return must be filed by, the credit amount cannot be determined because of taxpayers that do not file timely (e.g., taxpayers that file after being requested to do so through the department's filing enforcement program). In addition, current law does not establish a time limit for the filing of returns for a particular year if those returns show no tax liability. The author might consider amending the bill to divide the total amount available for distribution by the number of individuals who have filed an income tax return for the preceding taxable year by the extended due date of that return (generally October 15<sup>th</sup>). If the author wished to provide the credit for taxpayers who file a late income tax return, special provisions could also be added.
- \* This bill would require regular appropriations by the Legislature to pay for the refundable credit. The author may want to consider establishing a special fund into which the windfall profits tax would go, together with a statutory continuous appropriation of those funds to authorize payment of the refunds apart from the state general fund and annual budget processes.

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. Interest would have to be paid to refund recipients for the period of time the refund was delayed. This delay would result in additional contacts to the department by refund recipients, which would likely increase departmental costs.

- \* If this credit is interpreted to be a state public benefit, the proposed credit falls under the federal provisions making certain aliens ineligible for state public benefits. To establish eligibility, the claimant must declare himself/herself to be a citizen of the United States or an eligible alien. The FTB has no method in place to easily verify alien eligibility, and the volume of claims for this credit is anticipated to be large.
- \* An undetermined number of fraud investigators may be required by the department to verify this credit. Administrative costs of such investigators have not been determined at this time.

## **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 \$9.8 million to \$10.5 million. In addition, department staff anticipates that individuals who are not currently required to file an income tax return would file in future years only to be eligible for the credit. It is estimated that departmental costs would increase by at least \$3 million annually to process these additional tax returns.

## **ECONOMIC IMPACT**

Any revenue attributable to the windfall profits tax would be offset by equal amounts of refundable credits distributed to individuals who file an income tax return. Thus, there would be no revenue impact. In terms of cash flow timing between fiscal years, revenues collected would precede disbursements.

## **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 withholding the tax from the seller's payment would bring the tax into California, it is unknown whether the tax could withstand constitutional challenge. Further, providing an exemption from the tax for certain California-based local publicly-owned electric utilities and an exemption from the withholding requirements for distribution companies that are regulated by the Public Utility Commission of Nevada adds more uncertainty regarding a constitutional challenge.

The 100% tax rate could be considered confiscatory under the due process clause.

The windfall profits tax could be considered an indirect price regulation. Electricity price regulation is within the jurisdiction of the Federal Energy Regulatory Commission. This tax could be viewed as preempted by federal laws or regulations, and thus unconstitutional.

The "windfall profits tax" could be construed to be an income tax. 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 might be subject to P.L. 86-272. P.L. 86-272 would prohibit the imposition of the windfall profits tax if a seller's only business activity in the state is "solicitation" of orders for sales of electricity.

The law is unclear regarding whether or not electricity is tangible personal property. The legislative intent included in the bill (page 3, line 16 of the bill), uses the phrase "electrical services." That phrase could be interpreted to reflect the legislature's intent that electricity is not tangible personal property.

## **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 profit.
- \* This bill would provide a credit only to individual taxpayers. Thus, this bill would not help business entities, which also have been impacted by high electricity costs. Further, the bill could provide a benefit to individuals who receive power from a municipal utility district or other utility that has controlled costs and thus not subjected its ratepayers to the same price increases as other utility companies.

- \* Part-year residents or nonresident taxpayers would receive the full benefit of the credit even though they may not be experiencing California's energy crisis. However, amending the bill to deny the credit on the basis of residence could cause constitutional issues.
- \* To the extent that the taxpayer claimed a deduction on their federal return for state taxes paid, any credit applied against a taxpayer's state tax liability could be considered income that would be required to be reported on the federal income tax return for the year the credit is received.
- \* Historically, refundable credits, such as the former 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 is made that is later determined to be fraudulent. In such cases the refund commonly cannot be recovered.
- \* The bill would allow the credit to a taxpayer that can be claimed as a dependent by another taxpayer. For example, a minor child who has income from baby-sitting or lawn mowing may separately file and receive a credit.
- \* This bill does not contain a sunset date. Sunset dates generally are provided to allow periodic review by the Legislature.

#### **LEGISLATIVE STAFF CONTACT**

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