Franchise Tax Board — **ANALYSIS OF ORIGINAL BILL**

Author:	Aghazarian	Analyst:	Rachel Coco	Bill Number:	AB 288
Related Bills:	See Legislative History	Telephone:	845-4328	Introduced Date:	February 5, 2003
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Irrigation System Improvement Credit/Agricultural Water Filter Systems & Equipment Deduction

SUMMARY

This bill would allow:

- a credit for the cost of a farm irrigation system improvement that provides water conservation or savings, and
- a deduction for the costs of water filter systems and equipment used to prevent contaminated agricultural water from entering public waterways.

PURPOSE OF THE BILL

According to the author's office, this bill is intended to provide incentives to farmers and landowners to conserve diminishing resources.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would become effective immediately upon enactment and would apply to taxable years beginning on or after January 1, 2003.

POSITION

Pending.

Summary of Suggested Amendments

Amendments are provided to address the department's technical concern. Department staff is available to assist with amendments to resolve the implementation and policy concerns described below.

ANALYSIS

FEDERAL/STATE LAW

Existing state and federal laws allow a taxpayer to deduct expenses paid or incurred in the ordinary course of a taxpayer's trade or business. Expenses related to water conservation qualify to the extent that they are ordinary and necessary business expenses and are not for the purchase of property with a useful life of more than one year.

Board Position:			Department Director	Date
_____ S	_____ NA	_____ NP	Gerald H. Goldberg	03/13/2003
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Existing state and federal laws generally allow a depreciation deduction for the obsolescence or wear and tear of property used in a trade or business or for the production of income. The property must have a useful life of more than one year and includes equipment, machinery, vehicles, and buildings, but excludes land. The property is then depreciated over its useful life (recovery period).

Existing state law provides general rules that apply to the division of credits among two or more taxpayers, a husband and wife, and partners. State law also provides that any credit limitation applies at both the entity and individual taxpayer level, unless otherwise specified.

Existing state and federal laws allow taxpayers to use various credits against tax. Neither state nor federal laws currently have a tax credit or expense deduction similar to the ones proposed by this bill.

THIS BILL

Irrigation System Improvement Credit

This bill would allow taxpayers a tax credit equal to 30% of the costs of purchasing and installing an irrigation system improvement. The system must:

- be installed on land owned or leased by the taxpayer at the time of installation,
- be placed in service in this state,
- be used in a business for the production of farm income, and
- result in water conservation or savings.

This provision would extensively define the term “irrigation system improvement” in terms of the types of qualifying equipment and the impact on water use. An irrigation system improvement would also be defined to include a physical improvement, an alteration of real property, or an installation of equipment certified to meet the bill’s criteria. A registered civil engineer, registered agricultural engineer, or certified irrigation designer who is independent of the taxpayer and the seller or provider of the physical improvement, alteration, or equipment can provide the necessary certification.

The basis of the qualified irrigation system improvement would be reduced by the amount of the allowable credit.

Any excess credit would be carried over indefinitely. However, any unused carryover credit, including any carryover amount that could have been applied against the tax for the year in which the sale occurs, would be disallowed if the taxpayer sells the land on which the qualified equipment was installed.

Agricultural Water Filter Systems and Equipment Deduction

This provision would allow taxpayers engaged in an agricultural business (as defined) to elect to expense as a deduction the costs for the construction or purchase, or both, of water filter systems and equipment used to prevent contaminated agricultural water from entering public waterways or underground aquifers.

The election would be in a manner prescribed by the Franchise Tax Board (FTB) and would be irrevocable without the consent of FTB.

This provision would specify that if more than one taxpayer owns an agricultural business, each taxpayer may deduct that portion of the costs paid or incurred with respect to the water filter systems and equipment proportionate to the taxpayer's interest in the business.

The deduction would only apply to agricultural water filter systems and equipment placed in service in California.

This provision would define the terms "agricultural water filter system and equipment," "contaminated agricultural waters," and "qualified taxpayer."

IMPLEMENTATION CONSIDERATIONS

Irrigation System Improvement Credit

The credit permits, but does not require, an engineer or designer to provide certification of an irrigation system improvement. For audit purposes it is preferable if the taxpayer is required to have an engineer or designer certify the eligibility of an irrigation system for the credit because the department lacks the expertise in farming or water management necessary to determine if a system meets the required criteria.

The requirement that the certifying engineer or designer be independent of the taxpayer is a subjective, undefined standard and may be open to interpretation. Providing an objective relationship standard, perhaps by reference to an existing tax law standard defining a "related party," would make it clear that the engineer or designer may not be an employee or otherwise related to the purchaser, seller, or manufacturer of the water application or distribution equipment.

The credit does not specify a repeal date or any limitation on the carryover period. Credits typically are enacted with a repeal date to allow the Legislature to review their effectiveness. Recent credits have been enacted with a carryover period limitation since experience shows credits are typically used within eight years of being earned.

Agricultural Water Filter Systems and Equipment Deduction

It is unclear when the agricultural water filter systems and equipment constructed or purchased by the taxpayer would be required to satisfy the requirement to prevent contaminated water from entering public waterways or underground aquifers.

Current law specifies that the allocation of income, deductions, credits, and losses for partnerships and S corporations shall be on the basis of a partner's distributive share pursuant to a partnership agreement or an S corporation shareholder's pro rata share. This provision specifies that the deduction shall be allocated in accordance with the interest of each owner in an agricultural business; however, the bill does not provide any clear rule, such as profits interest or capital interests, to be used in determining owner interests.

TECHNICAL CONSIDERATIONS

Amendments are provided to clarify the effective dates of this bill.

LEGISLATIVE HISTORY

Irrigation System Improvement Credit

SB 435 (Monteith; 2001/2002) contained the same language as this bill, but failed to pass out of the Senate Revenue and Taxation Committee.

AB 63 (Cogdill/Garcia, 2002/2003) would allow a taxpayer a 25% credit for the cost of farm irrigation system improvements. AB 63 is currently in the Assembly Revenue & Taxation Committee.

AB 1054 (2001/2002), and AB 2570 (2001/2002), both authored by Cogdill, would have allowed a taxpayer a 25% credit for the cost of farm irrigation system improvements. Both failed to pass out of the Assembly Revenue and Taxation Committee.

Agricultural Water Filter Systems and Equipment Deduction

SB 1521 (Monteith, 1999/2000) contained similar deduction language as this bill, but failed to pass out of the Senate Revenue and Taxation Committee.

SB 1974 (Poochigian; 1999/2000) would have allowed an unspecified credit for the cost of a water filter system. This bill failed to pass out of the Senate Revenue and Taxation Committee.

PROGRAM BACKGROUND

Irrigation System Improvement Credit

A similar tax credit for the purchase and installation of water irrigation systems expired on December 31, 1985. That credit, taken in the year of installation, was equal to the lesser of 10% of the cost or a maximum of $500 and was provided in addition to any other qualified deductions.

OTHER STATES' INFORMATION

Review of *Florida, Illinois, Michigan, Minnesota, Massachusetts,* and *New York* laws found no comparable tax credits or deductions. These states were reviewed because of the similarities between California income tax laws and their tax laws.

FISCAL IMPACT

Once the implementation concerns are resolved, this bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in revenue losses beginning in 2003-04 as follows:

Revenue Impact of AB 288 Tax Years Beginning After 1/1/2003 Enactment Assumed After June 30, 2003 ($ Millions)			
	2003-4	2004-5	2005-6
Irrigation System Improvement Credit	-21	-26	-32
Water Filter Systems & Equipment Deduction	-5	-4	-4
Total Revenue Impact	-26	-30	-36

Any changes in employment, personal income, or gross state product that could result from this measure are not considered.

Revenue Discussion

Irrigation System Improvement Credit

Discussions with industry experts indicate that replacing existing systems as well as the incentive effect of this bill would induce approximately 199,000 acres of irrigated land in California to adopt water-saving systems or equipment annually. The average cost per acre to install the equipment and improve the irrigation system is projected at approximately $640 per acre for 2003. This figure was adjusted for inflation for subsequent years.

For the first tax year (2003), the impact for 199,000 acres would be $19 million (199,000 × $640 × .30 credit × .50 usage rate). The portion of credits that could be applied in any given year against available tax liabilities was estimated using tax returns that report farm income. This estimate was increased to a $21 million loss for the 2003/04 fiscal year due to the recent suspension of NOL deductions, which for some taxpayers increases the amount of credits that can be used.

Agricultural Water Filter Systems and Equipment Deduction

The estimates are based largely on information obtained from California experts in water/agriculture industry. This information indicates that there are no complete systems or equipment that filter or isolate contaminated water available for purchase.

For the first tax year (2003), the impact for 199,000 acres would be $4 million (199,000 × $500 × .50 usage rate × .08 tax impact). This estimate was increased to a $5 million loss for the 2003/04 fiscal year due to the recent suspension of NOL deductions which, for some taxpayers, increases the amount of credits that can be used.

A number of factors affect costs; soil condition and the type of contaminant are important factors. After discussions with industry experts, the average cost per acre was assumed to be $500. In California about 35 to 40% of acreage can benefit from this proposal due to soil conditions.

In order to comply with federal and state laws, about 40% of California irrigated land (9 million acres) have a filtering system already in place. A double-declining depreciation method was used to calculate deductions under current law assuming 18 years of depreciable life for a typical system. As a result, 1/18 of a typical system is assumed to be replaced each year, which would be eligible for expensing under this bill.

Note: This bill is identical to SB 435 (Monteith, 2001/2002). The differences in the revenue estimates are due to the inflation factor of 5% per year built into the model and the interaction with the 2002/2003 NOL suspension.

ARGUMENTS/POLICY CONCERNS

Irrigation System Improvement Credit

The credit recapture provision would create disparate treatment to taxpayers depending upon their status as a landowner or a lessee of farmland, as well as the timing of use of the credit to offset tax liability. For example, this provision would eliminate the credit carryover of an owner/taxpayer that purchases qualified water application equipment and then sells the land on which the qualified water application equipment had been installed. Conversely, it would allow a credit carryover to a taxpayer that leases the same land and terminates the lease after incurring the costs qualifying for this credit, even if the qualified water application equipment were removed from the leased property. Moreover, an owner/taxpayer that is able to fully utilize the credit against its tax liability in the year of installation would suffer no recapture penalty if the property were sold the following year. This is in contrast with an owner/taxpayer that was unable to use the credit prior to a sale.

Agricultural Water Filter Systems and Equipment Deduction

Current state and federal laws require businesses and individuals to minimize pollution from their businesses and other activities. This provision would allow a deduction for the construction or purchase of systems and equipment used to prevent contaminated agricultural water from entering public waterways. Tax benefits are typically enacted to encourage certain behavior, not to reward taxpayers that are simply complying with existing statutes and other laws.

Current federal and state laws allow taxpayers to elect to deduct certain expenses normally chargeable to a capital account. However, these deductions are subject to specified dollar limits (i.e., farm equipment is limited to $25,000). The deduction that is allowed by this bill is unlimited.

LEGISLATIVE STAFF CONTACT

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FRANCHISE TAX BOARD’S
PROPOSED AMENDMENTS TO AB 288
As Introduced February 5, 2003

AMENDMENT 1

On page 2, line 3, strikeout "There" and insert:

For each taxable year beginning on or after January 1, 2003, there

AMENDMENT 2

On page 3, line 29, strikeout “A” and insert:

For each taxable year beginning on or after January 1, 2003, a

AMENDMENT 3

On page 4, line 22, strikeout "There" and insert:

For each taxable year beginning on or after January 1, 2003, there

AMENDMENT 4

On page 6, line 7, strikeout "A" and insert:

For each taxable year beginning on or after January 1, 2003, a