ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author:	Aghazarian	Analyst:	Darrine Distefano	Bill Number:	AB 291
Related Bills:	See Legislative History	Telephone:	845-6458	Amended Date:	March 26, 2003
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Environmental Remediation Expenditure Credit/Allowed To Individuals Engaged In Agricultural Business Activity In San Joaquin River, Sacramento River, Or Tulare Lake Basins

____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended ____________.

X 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 ____________.

____ FURTHER AMENDMENTS NECESSARY.

____ DEPARTMENT POSITION CHANGED TO ____________.

____ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED ____________ STILL APPLIES.

X OTHER - See comments below.

SUMMARY

This bill would allow a credit for environmental remediation expenses.

SUMMARY OF AMENDMENTS

The March 26, 2003, amendments deleted language that would have increased the credit rate for the qualified research expense credit for environmental research and development costs and added the language discussed in this analysis.

The department's analysis of the bill as introduced February 5, 2003, no longer applies.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to assist taxpayers that are voluntarily monitoring environmental water pollutants in agricultural businesses.

EFFECTIVE/OPERATIVE DATE

This bill is a tax levy and would be effective immediately upon enactment and by its terms, operative for taxable years beginning on or after January 1, 2003, and before January 1, 2008.

Board Position:			Department Director	Date
____ S	____ NA	____ NP	Gerald H. Goldberg	4/23/03
____ SA	____ O	____ NAR		
____ N	____ OUA	X PENDING		

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

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.

Existing federal and state laws generally provide that the basis of property is its cost. Property acquired in a tax-deferred exchange for other property has a basis equal to the basis of the property given up. The original basis of property must be adjusted for expenditures that are properly capitalized, such as improvements, and for other amounts, such as depreciation.

Under federal law, taxpayers can elect to treat certain environmental remediation expenditures that would otherwise be chargeable to a capital account as deductible in the year paid or incurred (Internal Revenue Code (IRC) Sec. 198). The deduction applies for both regular and alternative minimum tax purposes. The expenditure must be incurred in connection with the abatement or control of hazardous substances at a qualified contaminated site. A “qualified contaminated site” generally is any property that (1) is held for use in a trade or business, for the production of income, or as inventory; (2) is certified by the appropriate state environmental agency to be located within a targeted area; and (3) contains (or potentially contains) a hazardous substance (so-called “brownfields”).

The federal Appropriations Act, 2001, extended the above-mentioned treatment to expenditures incurred before January 1, 2004. In addition, the Appropriations Act, 2001 eliminated the targeted area requirement, thereby expanding eligible sites to include any site containing (or potentially containing) a hazardous substance that is certified by the appropriate state environmental agency. However, expenditures undertaken at sites that are identified on the national priorities list under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 would continue to not qualify as eligible expenditures.

California is in conformity with federal law as it relates to environmental remediation expenditures paid or incurred on or after January 1, 2002, and before January 1, 2004. In addition, an election to deduct environmental remediation expenditures for federal purposes is applicable for California purposes. Once a taxpayer elects the federal deduction, the election automatically applies for California purposes. No separate election is allowed.

THIS BILL

This bill would allow a 25% credit for qualified environmental remediation expenditures paid or incurred by a qualified taxpayer. The credit would apply to taxable years beginning on or after January 1, 2003, and before January 1, 2008.

This bill defines “qualified environmental remediation expenditure” as any expenditure that is both of the following:
- Chargeable to a capital account.
- Paid or incurred in connection with abatement or control of wastewater, agricultural runoff, and other hazardous agricultural discharges at a qualified contaminated site.

This bill defines a “qualified taxpayer” as an individual under the Personal Income Tax Law (PITL) or taxpayer under the Corporation Tax Law (CTL)engaged in an agricultural business activity in the San Joaquin River, Sacramento River, or Tulare Lake basins.

This bill defines “agricultural business activity” as activities relating to any stock, dairy, poultry, fruit, furbearing animal, or truck farm, plantation, ranch, nursery, or range. It also includes activities relating to:

- cultivating the soil,
- raising or harvesting any agricultural or horticultural commodity that includes, but is not limited to, the raising, shearing, feeding, caring for, training, or management of farm animals, and
- handling, drying, packing, grading, or storing on a farm any agricultural or horticultural commodity in its unmanufactured state, but only if the owner, tenant, or operator of the farm regularly produces more than half of that commodity.

This bill defines “qualified contaminated site” as any area located within the San Joaquin River, Sacramento River, or Tulare Lake basins that is held by the qualified taxpayer for use in his or her agricultural business activity or for the production of income. There must also have been a release, threat of release, or disposal of any wastewater, agricultural runoff, or any other hazardous agricultural discharges at or on the area.

This bill would not allow the credit under this section if the taxpayer has elected the federal environmental remediation expense deduction for federal and state purposes.

This bill would allow the excess credit to be carried over indefinitely. This bill would be repealed on January 1, 2008.

IMPLEMENTATION CONSIDERATIONS

Since the department administers tax law and does not possess expertise in the agricultural field or hazardous material field, it would difficult for the department to verify the validity of any claimed credit. The author may wish to add language requiring a regional water quality control board to provide certification to the taxpayer of the release, threat of release, or disposal of wastewater, agricultural runoff, or any other hazardous agricultural discharges at the qualified contaminated site. A copy of the certification could then be provided to the department by the taxpayer upon request.

TECHNICAL CONSIDERATIONS

Department staff has identified the following technical considerations and is available to assist the author with the amendments.

The author may wish to rename the term “qualified environmental remediation expenditure” to “qualified agricultural environment remediation expenditure” or something similar to avoid confusion for the taxpayer and the department with the current federal and state environmental remediation expenditure. The federal provision relating to qualified environmental remedial expenditures is very broad, while this credit is specific to a taxpayer in the agricultural business. Using the same term for different types of expenditures could confuse the taxpayer as to which expenditure they should elect.

The bill would not allow the credit if the taxpayer has “elected” to expense the remediation expenditure under state law. However, there is in fact no election to expense an environmental remediation expense under state law. The election can only be taken under federal law and that federal election is specifically binding for state purposes, so no separate state election is required nor allowed. Therefore, the provision that denies the credit if the taxpayer elects the expense under state law is not applicable and should be revised.

The author may wish to replace the term “individual” with “taxpayer” for a “qualified taxpayer” under the PITL. This would allow entities such as partnerships, certain trusts, estates, and fiduciaries to claim the credit.

LEGISLATIVE HISTORY

AB 2797 (Cardoza, Stat. 1998, Ch. 322) conformed state law to federal law as it relates to the election to expense environmental remediation costs.

OTHER STATES’ INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws.

For environmental cleanup costs*, Florida* provides a 35% credit to corporations that voluntarily clean up specific sites for rehabilitation or designated brownfield sites.

Illinois offered a 25% credit to corporations for unreimbursed eligible remediation costs that were approved by the Illinois Environmental Protection Agency. This credit was repealed after January 1, 1998.

Massachusetts provides a 25% Brownfields Credit to corporations for clean up costs for a contaminated site in an economically depressed area.

Michigan provides a Brownfield Redevelopment Credit for the cost of eligible investment. Eligible investment means improvement of buildings or site improvements on eligible property. Remediation costs are not eligible investments.

Minnesota and *New York* do not offer a credit for environmental remediation expenses.

Research of these states did not find any credits or deductions for environmental remediation expenses in relation to agricultural runoffs or discharges.All of these states generally conform to federal law. However, research did not find that any of these states conform to the federal deduction since most offer a credit.

FISCAL IMPACT

This bill would not significantly impact the department’s costs.

ECONOMIC IMPACT

Revenue Estimate

The revenue impact of this measure, under the assumptions discussed below, is estimated to be as follows:

Revenue Impact of AB 291 Tax Years Beginning After 1/1/2003 Enactment Assumed After June 30, 2003 $ Millions			
	2003-4	2004-5	2005-6
Revenue Impact	–$8	-$8.5	-$9

This analysis does not account for changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

Data from the California Department of Water Resources show that the targeted three counties have a total of about 7 million acres of irrigated land. Discussion with industry experts indicated that a number of factors affect the costs of environmental remediation investments. The most important factors are soil condition as well as the type of contaminant. Following discussions with industry experts the average cost per acre was assumed to be $500. It was assumed that 40% of acreage in the counties impacted by this bill could benefit from this proposal due to soil conditions. It was further assumed that to comply with federal and state clean water acts, most of the farmers have already made some remedial investments in the past. The revenue impact would therefore be the result of replacement investments by the farmers. A useful life of 18 years was assumed for such investments.

The first year impact was arrived at as follows:

Qualified costs = $47,500,000;
Tax effect of deductions under current law = 0.08 × $47,500,000 = $3,800,000;
Tax effect of credits under proposed law = 0.25 × $47,500,000 = $11,875,000;
Revenue impact = $11,875,000 – $3,800,000 = $8,075,000

ARGUMENTS/POLICY CONCERNS

This bill does not limit the number of years for the carryover period. The department would be required to retain the carryover on the tax forms indefinitely because an unlimited credit carryover period is allowed. Recent credits have been enacted with a carryover period limitation since experience shows credits are typically used within eight years of being earned.

Conflicting tax policies come into play whenever a credit is provided for an item that is already deductible as a business expense or is otherwise reflected as an adjustment to the basis of property for tax purposes. Providing both a credit and allowing the full amount to be deducted (or added to basis) would have the effect of providing a double benefit for that item or cost. On the other hand, making an adjustment to deny the deduction or reduce basis in order to eliminate the double benefit creates a difference between state and federal taxable income, which is contrary to the state's general federal conformity policy.

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