

Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Klehs Analyst: Anne Mazur Bill Number: AB 2442

Related Bills: See Legislative History Telephone: 845-5404 Introduced Date: February 23, 2006

Attorney: Patrick Kusiak Sponsor:

SUBJECT: Corporation Petroleum Surtax

SUMMARY

This bill would impose a surtax on California corporate net income that arises from business activities in the petroleum industry.

PURPOSE OF THE BILL

According to the author's staff, the purpose of this bill is to redistribute historically large petroleum business profits for the benefit of California citizens.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment. The bill specifies that it would apply for taxable years beginning on or after July 1, 2005.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Existing federal income tax law contains provisions unique to taxpayers in the oil and gas industry, such as an enhanced oil recovery credit, the option to use cost or percentage depletion in some circumstances, special expensing of intangible drilling and development costs, and restrictions on the foreign tax credit for foreign oil and gas extraction income.

California law generally conforms to federal law on depletion and intangible drilling and development costs. California also allows an enhanced oil recovery credit equal to one-third of the federal credit for projects located within California. However, state law does not allow the foreign tax credit. Excess intangible drilling and development costs are treated as a preference item for alternative minimum tax purposes. In addition, there is an exception to the double-weighted sales factor for certain business activities, including those activities relating to the

Table with Board Position (S, SA, N, NA, O, OUA, NP, NAR, PENDING) and Department Director (Selvi Stanislaus) with Date (04/05/06).

production, refining, or processing of oil and gas. Such activities are subject to an apportionment formula with a single-weighted sales factor.

Prior federal law in effect from 1980 to 1988 imposed an excise tax on certain oil windfall profits. The tax rate ranged from 15% to 70% of the difference between the market price of oil and a predetermined base price. Currently, there is no federal tax on oil windfall profits; however, there are numerous proposals under consideration in both houses of Congress. California has no history of enacted legislation imposing a state-level windfall profits tax.

Existing California law imposes a franchise tax, measured by net income, on every corporation doing business in this state, whether organized in-state or out-of-state. The corporation franchise tax rate is 8.84%. The S corporation franchise tax rate is 1.5%. California law also imposes an income tax on corporations that are not doing business in California, but are deriving income from California sources. This tax rate is also 8.84% and 1.5% for general corporations and S corporations, respectively.

THIS BILL

This bill would impose a 2% surtax on net income in excess of \$10 million that is apportioned to California and arises from business activities in the petroleum industry. The surtax would be in addition to any other corporate franchise and income tax.

The term "business activities in the petroleum industry" would be defined to mean petroleum producing and refining activities, as described in specified sections of the North American Industry Classification System (NAICS) Manual published by the United States Office of Management and Budget, 2002 Edition.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

Implementation of the surtax for taxable years beginning on or after July 1, 2005, would be problematic if this bill is enacted after tax returns and tax for that year are due. The department would need to develop and implement transitional procedures, including noticing taxpayers and creating new and revising existing forms, for reporting the tax due for the 2005 taxable year. To provide clarity for the department and taxpayers, the bill should be amended to include transitional provisions to address the payment of the surtax for the 2005 taxable year, such as a payment due date that is 60 days after the date of enactment, with interest accruing from that date. In the alternative, the author may want to consider making the bill operative for taxable years beginning on or after January 1, 2006.

This bill would require modification of existing corporation tax forms and instructions for computing and reporting the surtax.

This bill also would require modification of systems, including the business entities accounting, nonfiler, return processing and cashiering systems, to account for and issue assessments of the additional tax. Most of these changes could be accomplished during the normal annual update.

This bill would impose the surtax on net income in excess of \$10 million that “arises from business activities in the petroleum industry.” It defines “business activities in the petroleum industry” as those lines of business described in specified standard industry classifications. This could be read to require the income of a taxpayer to be broken down between various lines of business, which would be difficult for both taxpayers and the department to administer. It is recommended that the author consider amending the bill to apply to a taxpayer that is engaged in the petroleum industry or for a taxpayer that has some minimum level of its property, payroll, or sales in that industry. The bill could also be clarified as to whether such a test would be on an entity or unitary business basis.

Department staff assumes the surtax would be applied in the same manner as franchise or income tax for purposes of applying administrative provisions and other corporation tax provisions of the Revenue and Taxation Code, such as application of estimated tax, penalties, alternative minimum tax, and credits.

If this bill were amended to resolve these implementation considerations, implementing this bill would be accomplished during the normal annual update.

LEGISLATIVE HISTORY

AB 673 (Klehs, 2005/2006) would have imposed a 2.5% tax on the windfall profits of petroleum producers and refiners. The bill failed passage on the Assembly Floor.

ABX 128 (Corbett and Wiggins, 2001/2002) and ABX2 2 (Corbett and Wiggins, 2001/2002) were identical. These bills would have imposed a tax on excess gross receipts from electrical energy distribution and required electricity purchasers to withhold and remit the tax. SBX 128 was held in the Assembly Appropriations Committee. ABX2 2 failed passage on the Assembly floor.

SBX 1 (Soto, 2001/2002) and SBX2 1 (Soto, 2001/2002) would have imposed an Electricity Windfall Profits Tax on sellers of electricity and would have refunded the amount collected to individuals that filed a tax return. SBX 1 was held on the Assembly when the first extraordinary session ended. SBX2 1 failed passage on the Assembly floor.

SB 14 (Thompson, 1995/1996) and SB 1777 (Burton, 1999/2000) would have imposed a Petroleum Windfall Profits Tax on certain taxpayers engaged in petroleum refining. SB 14 failed passage in the Assembly Revenue and Taxation Committee. SB 1777 was held in the Senate Rules Committee.

FISCAL IMPACT

The department's costs to administer this bill cannot be determined until implementation concerns have been resolved but are anticipated to be significant.

ECONOMIC IMPACT

Revenue Estimate

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

Revenue Impact of AB 2442 Enactment Assumed After June 30, 2006 in millions		
2006-07	2007-08	2008-09
+ \$115	+ \$140	+ \$180

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

Revenue Discussion

Micro-level data on a sample of California petroleum producers and refiners were used to estimate the revenue impact of this proposal. The state net incomes (SNIs) of these taxpayers were projected into the future using financial information from public-domain sources and expert judgment. A surtax of 2% was then applied to the excess of SNI in any taxable year over \$10,000,000. It was assumed that this proposal would be enacted sometime after June 30, 2006.

For the 2006 taxable year, excess SNIs for California petroleum producers and refiners is forecast¹ to be approximately \$5.7 billion resulting in \$115 million ($\$5.7 \text{ billion} \times 0.02$) of tax revenue.

ARGUMENTS/POLICY CONCERNS

This bill does not contain a sunset date. Sunset dates generally are provided to allow periodic review by the Legislature.

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¹ Projected income for 2006 is based on data published in The Value Line Investment Survey.