

SUMMARY ANALYSIS OF AMENDED BILL

Author: Klehs Analyst: Anne Mazur Bill Number: AB 2442
 Related Bills: See Legislative History Telephone: 845-5404 Amended Date: April 6, 2006
 Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Petroleum Surtax/Prescription Drug 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 DEPARTMENTS 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.

OTHER – See comments below.

SUMMARY

This bill would establish the following:

1. A petroleum surtax on corporations and individuals.
2. A prescription drug credit for seniors.

Each of these provisions is discussed separately in this analysis. For convenience, all applicable sections of the analysis of the bill as introduced on February 23, 2006, is included in this analysis.

SUMMARY OF AMENDMENTS

The April 6, 2006, amendments deleted and added provisions relating to the imposition of a petroleum surtax and added a provision to establish a prescription drug credit for seniors.

| | | |
|--|----------------------|---------|
| Board Position: | Legislative Director | Date |
| <input type="checkbox"/> S <input type="checkbox"/> NA <input type="checkbox"/> NP <input type="checkbox"/> SA <input type="checkbox"/> O <input type="checkbox"/> NAR <input type="checkbox"/> N <input type="checkbox"/> OUA <input checked="" type="checkbox"/> PENDING | Brian Putler | 4/13/06 |

PURPOSE OF THE BILL

According to staff, the purpose of this bill is to redistribute historically large petroleum business profits for the benefit of California citizens by providing relief to low- and middle-income seniors for the high cost of prescription drugs.

POSITION

Pending.

SUMMARY OF ECONOMIC IMPACT

| Estimated Revenue Impact of AB 2442 Enactment Assumed After June 30, 2006 (in millions) | | | |
|---|---------|---------|---------|
| | 2006/07 | 2007/08 | 2008/09 |
| Petroleum Surtax | + \$120 | + \$150 | + \$190 |
| Prescription Drug Credit | - \$120 | - \$150 | - \$190 |
| Net Revenue Impact | None | None | None |

This estimate does not consider the possible changes in employment, personal income, or gross state product that would result from this bill.

Individual revenue discussions are included separately below for each provision.

Summary of Suggested Amendments

See attachment for technical amendments to correct grammar, references, and definitions.

1. PETROLEUM SURTAX

EFFECTIVE/OPERATIVE DATE

As a tax levy, this provision would be effective immediately upon enactment. The bill specifies that it would apply for taxable years beginning on or after July 1, 2005, and before July 1, 2010.

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 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 PROVISION

This provision of the bill would impose a 2% surtax on individuals and business entities including corporations engaged in business activities in the petroleum industry. The surtax would apply to net income in excess of \$10 million. The surtax would be in addition to, but treated the same as, the current personal income tax or corporation franchise and income tax.

The term "taxpayer engaged in business activities in the petroleum industry" would mean a taxpayer that has more than 50% of its gross business receipts, as defined, derived from conducting one or more qualified business activities. Those activities would include petroleum producing, refining, wholesaling and retailing 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.

In the case of a unitary group required to be included in a combined report, the 50% test would apply at the group level.

In the case of pass-through entities (PTE), the bill specifies that the 50% test would apply at both the entity and investor level. An investor in a PTE that both meets the 50% test and has net income in excess of \$10 million would be subject to the surtax on the investors distributive or pro

rata share of that income. In addition, any PTE that engages in petroleum activities must separately state the gross business receipts of those activities regardless of whether the 50% test is met at the entity level. If an investor in a PTE meets the 50% test, the investor would be required to aggregate its distributive or pro rata share of net income for all the investor's PTEs – to the extent the PTE net income did not exceed the \$10 million threshold at the entity-level – along with the investor's net income from other sources for purposes of applying the \$10 million threshold.

This provision would: authorize FTB to issue regulations and be repealed by its own terms on December 31, 2011.

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 individual and business entity tax forms and instructions for computing and reporting the surtax.

This bill also would require modification of systems, including the individual and business entity 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.

TECHNICAL CONSIDERATIONS

The bill would define the term "pass-through entity" as "any partnership, including any entity classified as a partnership for California tax purposes, or any "S" corporation." The term "partnership" as used in the Internal Revenue Code and in the Personal Income Tax Law (PITL) and Corporation Tax Law (CTL) includes entities organized as partnerships and other entities organized as limited liability companies, trusts, and other business entities that are treated as partnerships for tax purposes. Including the phrase "including any entity classified as a partnership for California tax purposes" -- which is not used elsewhere in PITL, CTL, or in the IRC -- could be interpreted to erroneously imply that the term "partnership" does not already include

such entities. Deletion of the unnecessary and problematic phrase is recommended. See Amendments 3 and 11.

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 are identified and resolved, but are anticipated to be significant, particularly if an additional line is added on certain tax returns to capture the surtax data. An additional line could require new system programming, forms design, and forms printing.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, the petroleum surtax provisions of the bill would result in the following revenue gains.

| Revenue Impact of Petroleum Surtax Enactment Assumed After June 30, 2006 (in millions) | | |
|--|---------|---------|
| 2006/07 | 2007/08 | 2008/09 |
| + \$120 | + \$150 | + \$190 |

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

Revenue Discussion

Micro-level data on a sample of California petroleum producers, refiners, wholesalers, and retailers 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 corporate petroleum producers, refiners, wholesalers, and retailers is forecast¹ to be approximately \$5.7 billion resulting in \$115 million (\$5.7 billion \times 0.02) of tax revenue. The inclusion of personal income taxpayers would add another 5% to the revenue impact resulting in a total gain for the first fiscal year of \$120 million.

2. PRESCRIPTION DRUG CREDIT

EFFECTIVE/OPERATIVE DATE

As a tax levy, this provision would be effective immediately upon enactment. The bill specifies that it would apply for taxable years beginning on or after January 1, 2006, and before January 1, 2011.

ANALYSIS

FEDERAL/STATE LAW

Current federal law, to which California conforms, specifically allows unreimbursed medical care expenses, including costs for certain medicine and drugs, to be deducted for income tax purposes. The expenses may be claimed as an itemized deduction only to the extent that they exceed 7.5% of the taxpayer's adjusted gross income (AGI). Federal law provides that costs for medicine and drugs may be deducted if the medicine or drug is prescribed or is insulin.

Current federal and state laws contain various tax credits designed to provide tax relief for taxpayers that incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

Neither current federal nor state law has a tax credit comparable to the prescription drug credit proposed by this bill.

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

THIS PROVISION

This provision would establish a credit in the amount of a percentage of unreimbursed amounts paid for prescription drugs for the medical care of individuals 65 years of age or older. That individual may be the taxpayer, the taxpayer's spouse, or the taxpayer's dependent. The credit amount would be 25% of such amounts for the first taxable year beginning on or after January 1, 2006, and 28% for each taxable year thereafter. Only taxpayers with California AGI less than \$100,000 for joint filers and \$50,000 for head of household, single, and married filing separate may claim the credit.

No deduction would be allowed for any amount paid for prescription drugs during the taxable year for which a credit is allowed.

This provision would be repealed by its own terms on December 31, 2011.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

LEGISLATIVE HISTORY

SB 155 (Oller, 2001/2002) would have allowed a refundable credit to individuals 55 years of age or older for 100% of their prescription drugs that are not reimbursable by a third party. This bill was held in the Senate Revenue and Taxation Committee.

AB 1166 (Bill Campbell, 2001/2002) would have created a 25% credit for seniors 65 years of age or older for the costs of prescription drugs. This bill was held in the Assembly Revenue and Taxation Committee.

AB 2533 (Pacheco, 1999/2000) would have allowed a 25% prescription drug credit limited to specified annual maximum amounts. This bill was held in the Assembly Revenue and Taxation Committee.

FISCAL IMPACT

This provision would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, the prescription drug credit provisions of the bill would result in the following revenue losses.

| Revenue Impact of Prescription Drug Credit Enactment Assumed After June 30, 2006 (in millions) | | |
|--|---------|---------|
| 2006/07 | 2007/08 | 2008/09 |
| – \$120 | – \$150 | – \$190 |

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

Revenue Discussion

The revenue impact of the prescription drug credit would be determined by the amount of unreimbursed costs incurred by qualified taxpayers for prescription drugs and the amount of credits that could be applied to reduce tax liabilities.

Based on household spending data, the average annual out-of-pocket expenditure for prescription drugs by individuals age 65 and older was projected at \$993 for 2006. A simulation was performed using personal income tax sample data. As the proposed credit is for 25% of unreimbursed costs in 2006, the senior exemption credit is increased by \$248 as a proxy for the new credit ($\$993 \times 25\% = \248). Assuming each qualified taxpayer in the sample generates the average credit, the simulation models the maximum revenue loss to the extent credits generated could be applied to reduce tax liabilities. A similar simulation was performed for 2007 and subsequent years increasing the credit to 28% of unreimbursed costs.

The model results are adjusted to allow for: (1) some small portion deducted under present law as a medical expense and (2) to reflect the rate at which qualified taxpayers would actually report the credit on their tax returns. For 2006, these adjustments reduced the model result from losses of \$155 million to \$100 million. Each successive year the rate at which qualified taxpayers report the credit increases and, therefore, has less of a reduction effect on model results.

Taxable year estimates are converted to cash flow fiscal year revenue estimates as reflected in the table.

LEGISLATIVE STAFF CONTACT

Anne Mazur
Franchise Tax Board
(916) 845-5404
anne.mazur@ftb.ca.gov

Brian Putler
Franchise Tax Board
(916) 845-6333
brian.putler@ftb.ca.gov

Analyst Anne Mazur
Telephone # 916-845-5404
Attorney Patrick Kusiak

FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO AB 2442
As Amended April 6, 2006

AMENDMENT 1

Page 3, line 22, strikeout "pro rate" and insert:

pro rata

AMENDMENT 2

Page 3, line 29, strikeout "are" and insert:

is

AMENDMENT 3

Page 3, line 34, strikeout "partnership, including" and
strikeout line 35 and insert:

partnership

AMENDMENT 4

Page 4, line 15, strikeout "subdivision (b)" and insert:

paragraph (2)

AMENDMENT 5

Page 4, line 18, strikeout "subdivision (b) of Section 213 of
the federal" and insert:

Section 213(b) of the

AMENDMENT 6

Page 4, line 21, after "the" insert:

first

AMENDMENT 7

Page 4, line 29, ~~subdivision (a) of Section 213 of the federal~~ and insert:

Section 213(a) of the

AMENDMENT 8

Page 5, line 16, ~~on~~ and insert:

of

AMENDMENT 9

Page 6, line 22, ~~pro rate~~ and insert:

pro rata

AMENDMENT 10

Page 6, line 29, ~~are~~ and insert:

is

AMENDMENT 11

Page 6, line 34, ~~partnership, including~~ and ~~strikeout line 35~~ and insert:

partnership