

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 October 1, 2005, and before October 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 5% surtax on individuals and corporations engaged in business activities in the petroleum industry. The surtax would apply to taxable or 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. This provision would not apply to small refiners, as defined.

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 meets both the 50% test and has net income in excess of \$10 million would be subject to the surtax on the investor's 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 October 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.

LEGISLATIVE HISTORY

AB 2442 (Klehs, 2005/2006) would have established a 2% petroleum surtax and a motor vehicle fuel tax offset in an amount equal to the surtax. Except for the surtax rate, the provisions contained in AB 3075 are identical to the provisions of AB 2442. The bill was held on the Assembly Floor.

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. ABX 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 in 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 would be significant, particularly if an additional line is added on certain tax returns to capture the surtax data. An additional line would 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 |
| + \$300 | + \$375 | + \$475 |

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 5% 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 \$285 million (\$5.7 billion \times 0.05) 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 \$300 million.

As described for the motor vehicle fuel sales tax exemption, the BOE would be required to determine and implement a revenue reduction equal to, and in order to offset, the revenue increase attributable to the petroleum surtax based on estimates provided by FTB.

2. MOTOR VEHICLE FUEL SALES TAX EXEMPTION

EFFECTIVE/OPERATIVE DATE

As a tax levy, this provision would be effective immediately upon enactment. The bill specifies that it would apply for the period commencing on January 1, 2007, and ending on December 31, 2010.

ANALYSIS

THIS PROVISION

This provision would provide a sales and use tax exemption with respect to motor vehicle fuel, as defined, measured by the amount of revenue generated by the petroleum surtax. The exemption would be applied by reducing the sales or use tax imposed on each gallon of motor vehicle fuel by an offset amount. The "offset amount" would mean the amount necessary to reduce the sales or use tax revenues on motor vehicle fuel by an amount equal to the increase in revenues derived from the petroleum surtax provisions for specified periods as follows:

- For January 1, 2007, through June 30, 2007, the offset amount would be based on the revenue increase from the petroleum surtax for October 1, 2005, through June 30, 2007.
- For the fiscal year beginning July 1, 2007, and each fiscal year thereafter until the provision is repealed, the offset amount would be based on the revenue increase from the petroleum surtax for the same fiscal year.

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

FTB would be required to cooperate with BOE in providing estimates of revenues from the petroleum surtax to facilitate BOE in implementing this provision.

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

IMPLEMENTATION CONSIDERATIONS

Except for the requirement for FTB to provide revenue estimates, this provision would be administered by the BOE and, therefore, implementing this bill would not significantly impact the department's programs and operations.

As noted, this bill would require FTB to cooperate with BOE in providing estimates of revenues from the petroleum surtax required to implement this provision. BOE would also be required to take into account the actual amount of revenues derived in prior years in order to ensure that the sales tax offset amount equals petroleum surtax revenue. FTB is constrained in providing actual amounts for the following reasons:

- For the 2006 taxable year, FTB would be unable to determine the amount of the surtax reported on calendar year returns until approximately 6 months following the October 15, 2007 extended due date of returns.
- FTB would be unable to translate taxable year revenue impact to fiscal year impact, as appears to be required by this bill. This difficulty arises because tax payments made for a tax year are made in more than one fiscal year. It is unfeasible to determine to what extent the payments in any particular fiscal year would be adjusted to account for the proposed surtax.

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

FISCAL IMPACT

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

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