

SUMMARY ANALYSIS OF AMENDED BILL

Author: Klehs Analyst: Anne Mazur Bill Number: AB 673
 Related Bills: See Prior Analysis Telephone: 845-5404 Amended Date: January 5, 2006
 Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Petroleum Windfall Profits Penalty

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 AMENDED

 January 4, 2006 . STILL APPLIES.

OTHER – See comments below.

SUMMARY

This bill would impose a penalty on windfall profits realized by petroleum producers and refiners.

SUMMARY OF AMENDMENTS

The proposed amendment would extend the operative period of the provisions of this bill by one year by revising the taxable years to which the provision applies from taxable years beginning before January 1, 2008, to taxable years beginning before January 1, 2009.

Except for the items below, the remainder of the department’s analysis of the bill as amended January 4, 2006, still applies.

POSITION

Pending.

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	01/23/06

ANALYSIS

IMPLEMENTATION CONSIDERATIONS

Department staff identified the following implementation considerations. Staff is available to work with the author's office to resolve these issues and any additional implementation concerns that may be identified as the bill moves through the legislative process.

According to the author's office, the penalty would be a strict liability penalty and would be self-assessed on a taxpayer's tax return for the current taxable year. As such, staff suggests the bill be amended to clarify that the penalty becomes due and payable on the last date prescribed by law for the payment of the tax, i.e., generally the original due date of the return. Consistent with other self-assessed penalties, staff further suggests that the bill be amended to clarify, if the penalty is not paid or underpaid, that the penalty would be due upon notice and demand.¹

Implementation of this penalty for the 2005 taxable year would be problematic if this bill is enacted after tax returns for that year are due to be filed. The department would need to develop and implement transitional procedures, including noticing taxpayers and creating new and revising existing forms, for handling the penalty 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 this penalty 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.

This bill would base the penalty computation on business net income apportioned to California for both current and the prior five years. Any time that any of those amounts are revised by the taxpayer or by the department, the penalty would have to be recomputed. In addition, a taxpayer's records for the prior five years would need to be maintained in order for that information to be available for the penalty computation.

Presumably, the determination of whether the taxpayer is a producer or refiner would be made for the current year; however, this is not clear from the bill language.

The bill authorizes FTB to prescribe rules and regulations to implement the provisions of the bill, particularly on how to take into account mergers, acquisitions, and divestitures occurring during the base year period. The regulation process is often lengthy and cumbersome. It is not clear how these matters would be handled prior to the issuance of such guidance. Furthermore, such guidance would also be necessary if a merger, acquisition, or divestiture occurred in the current year.

This bill would require modification of existing individual and business entity tax forms, in addition to designing worksheets or schedules and instructions for computing and reporting the penalty.

¹ Such treatment would require a taxpayer to pay the penalty and file a claim in order to dispute the assessment of the penalty. The business community has been very vocal in opposition of the imposition of penalties, such as the amnesty penalty, that have no right of pre-payment review.

TECHNICAL CONSIDERATIONS

The bill provides for a repeal date of January 1, 2009. Because the bill was amended to extend the operative period of the provisions of this bill to taxable years beginning before January 1, 2009, the bill should be amended to revise the repeal date to January 1, 2010.

The bill specifies that the penalty would be imposed in addition to any other "tax" imposed under Parts 10 or 11 of the Revenue and Taxation Code (R&TC). Staff suggests that the bill be amended to specify that the penalty also would be imposed in addition to any other "penalty" imposed under those parts, or Part 10.2.

ECONOMIC IMPACT

Revenue Estimate

The revenue impact of this bill, under the assumptions discussed below, would result in the following gains:

Revenue Impact of AB 673 Enactment Assumed After June 30, 2006 in millions		
2006-07	2007-08	2008-09
+\$140	+\$70	+\$90

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

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 incomes of these taxpayers were projected into the future using financial information from public-domain sources and expert judgment. A penalty of 2.5% was then applied to the excess of income in any taxable year over the average of the incomes for the five immediately preceding taxable years. Staff assumed that this proposal would be enacted sometime after June 30, 2006.

For the 2005 tax year, the apportioned income for California petroleum producers and refiners is forecast² to be approximately \$6.9 billion. The 2005 gross base year adjusted net income is forecast to be approximately \$3.3 billion. The estimated "windfall profits" are, therefore, approximately \$3.6 billion. Multiplying the "windfall profits" by the 2.5% penalty rate generates a revenue gain of approximately \$90 million. As noted below, penalty payments attributable to 2005 would not be due until sometime in the 2006-07 fiscal year. Both penalty payments

² Projected income for 2005 is based on data published in The Value Line Investment Survey.

attributable to taxable year 2005 and attributable to taxable year 2006 would be realized in the 2006-07 fiscal year.

For purposes of this estimate, department staff assumed the following:

- The penalty payment would be due on the date prescribed for paying tax (generally the original due date of the return), unless the due date occurs before enactment of this bill. In that case, the payment due date would be some date on or after the enactment date.
- No estimated tax penalties would be assessed.
- This bill will be amended to expressly provide for each of these items.

LEGAL IMPACT

The windfall profits penalty could be considered an indirect price regulation. The Federal Energy Regulatory Commission regulates only a segment of the industry, namely oil pipelines. However, the provisions added by this bill could be viewed as preempted by federal laws or regulations, and thus unconstitutional.

ARGUMENTS/POLICY CONCERNS

The author may want to consider applying a growth factor to the base year adjusted net income. The current language provides for the base year to be determined by reference to an average of business income apportioned to California over the five immediately preceding taxable years. While such a method has the effect of smoothing peaks and valleys in earnings, it can result in application of the penalty to what might be perceived as normal, in addition to windfall, profits.

This bill could be viewed as inequitable as it would impose a penalty on large profits reported by a single industry that already is subject to state taxation to the extent income is derived from California sources.

If a taxpayer or unitary group of taxpayers conducts business activities other than petroleum production or refining, the penalty would apply to "windfall profits" attributable to those other activities.

The bill defines "windfall profits" with reference to the excess of adjusted net income over base year adjusted net income. Current year net income, prior year net income, or the base year average could be negative amounts, i.e., losses. Therefore, the excess of current year apportioned business over the base year amount could be an amount that is greater than positive business income apportioned to California. For example, if a taxpayer's adjusted net income is \$10 million and the base year adjusted net income is negative \$2 million, then the windfall profit upon which the penalty would apply is \$12 million.

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