Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Alquist	Analyst:	Nicole Kwon	Bill Number:	SB 1484
Related Bills:	See Legislative History	Telephone:	845-7800	Amended Date:	March 28, 2008
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Clean Energy Technology Credit/Disallow Credits And Deductions To Taxpayers Engaged In Oil Production Business

SUMMARY

This bill would create a credit for certain taxpayers for qualified equipment relating to the clean energy technology and disallow credits and other incentives for taxpayers engaged in the business of oil production.

SUMMARY OF AMENDMENTS

The March 28, 2008, amendments would do the following:

- Remove the previous provisions relating to intent language to create incentives for clean technology developers to manufacture in California.
- Replace them with provisions that would do the following:
  - Allow a credit for qualified costs related to clean energy technology, and
  - Repeal credits to taxpayers engaged in the business of oil production.

This is the department's first analysis of the bill.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to encourage businesses to increase their expenditures and investment in California clean energy technology.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately. The clean energy technology credit would be specifically operative for taxable years beginning on or after January 1, 2011, and before January 1, 2016. Other provisions of the bill related to the repeal of the research & development credit and percentage depletion deduction for oil industry would be operative for taxable years beginning on or after January 1, 2008.

POSITION

Pending.

Board Position:			Department Director	Date
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______ N	______ OUA	__X__ PENDING		

ANALYSIS

FEDERAL/STATE LAW

Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers who 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.

A. Manufacturers' Investment Credit

From 1994 until 2003, state law allowed qualified taxpayers a Manufacturers' Investment Credit (MIC) equal to 6% of the qualified costs paid or incurred for qualified property that was placed in service in California.

For purposes of the MIC, a qualified taxpayer was any taxpayer engaged in manufacturing activities described in specified codes listed in the Standard Industrial Classification (SIC) Manual, 1987 edition. Qualified property was any of the following:

1) Tangible personal property that is defined in Section 1245(a) of the Internal Revenue Code (IRC) and used in a qualified SIC Code activity that is used primarily for the following:
    - Manufacturing, processing, refining, fabricating, or recycling of property;
    - Research and development;
    - Maintenance, repair, measurement, or testing of otherwise qualified property; or
    - Pollution control that meets or exceeds state or local standards.
2) The value of any capitalized labor costs directly allocable to the construction or modification of the property listed in #1 above or for special purpose buildings and foundations listed in #3 below.
3) Special purpose buildings and foundations that are an integral part of specified activities.

For taxpayers engaged in computer programming and computer software-related activities, qualified property included computers and computer peripheral equipment used primarily for the development and manufacture of prepackaged software and the value of any capitalized labor costs directly allocable to such property.

The MIC explicitly excluded certain types of property from the definition of qualified property, such as furniture, inventory, and equipment used in an extraction process.

The MIC statute was repealed by its own terms and ceased to be operative due to the number of manufacturing sector jobs in California no longer meeting the MIC statutory requirements.

B. Depletion

Depletion Deduction – Under both federal and California law, all exhaustible natural deposits such as mines, oil, and gas qualify for deduction of a reasonable allowance for depletion based on the taxpayer's cost or other basis of the resource (i.e. cost depletion).

Percentage Resource Depletion Allowance Deduction – This provision allows taxpayers to deduct from income a fixed percentage for resource depletion. The percentage depends on the type of resource, and the depletion allowance cannot be more than 50% of a taxpayer's related net income prior to the depletion deduction, or more than 100% in the case of oil and gas properties.

California conforms to federal tax law regarding the percentage depletion for oil and gas wells, and for geothermal deposits. The depletion rates are limited to 22% for regulated domestic natural gas, 10% for natural gas from geopressurized brine[1], 15% for domestic crude oil and natural gas from certain independent producers, and 15% for geothermal deposits located in the U.S.

C. Oil and Gas Industry Income Tax Incentives

Intangible Drilling And Development Costs (IDC)

Current federal law allows taxpayers the option to capitalize, amortize (over 60 months), or immediately expense IDCs for oil, gas, and geothermal wells located within the United States.[2] For state purposes, California allows the option for oil and gas wells only.[3] Deducted IDCs are recaptured as ordinary income on disposition of the oil or gas well. [4]

For years beginning on or after January 1, 1987, neither federal nor California permit expensing of IDCs relating to costs paid or incurred with respect to an oil, gas, or geothermal well located outside the United States.

Enhanced Oil Recovery Credit

Existing federal law provides the enhanced oil recovery credit for any taxable year in an amount equal to 15% of the taxpayer's qualified enhanced oil recovery costs for such taxable year.

Under state law, for taxable years beginning on or after January 1, 1996, taxpayers are allowed a 5% credit for costs of enhanced oil recovery projects that apply to qualified tertiary recovery methods.[5] An election not to take the federal credit is binding and irrevocable for California purposes. In this situation, the federal credit is considered to be zero.

Taxpayers who are retailers of oil or natural gas or who are refiners of crude oil whose daily output exceeds 50,000 (75,000 for federal) barrels are not eligible for the credit. The credit is phased out as the average per barrel wellhead[6] price of domestic crude oil (reference price) for the previous tax year exceeds $28. Excess credit is allowed to be carried over for the next 15 years. The California enhanced oil recovery credit only applies to projects located within the state.

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[1] Natural gas produced from a well whose drilling began after 9-30-1978 and before 1-1-1984. R & TC section 24831.
[2] IRC sections 59(e) and 263(c).
[3] Revenue and Taxation Code (R&TC) sections 17062, 23400, 23459, and 24423
[4] IRC section 1245(a) (1) (A). R&TC sections 18151, 24990, and 24990.6.
[5] Injecting hydrocarbon gas into an oil or gas well to increase pressure for recovery.
[6] Part of an oil well that terminates at the surface, whether on land or offshore, where petroleum or gas hydrocarbons can be withdrawn.

Tertiary Injectant Expenses

A "tertiary recovery method"[7] means injecting hydrocarbon gas into an oil or gas well to increase pressure for recovery. For federal purposes, tertiary injectant expenses are deductible in the year that the injections were made.[8]

California does not conform to the federal treatment. For California and financial reporting purposes, if tertiary costs enhance the recovery process, they are capitalized and amortized over the life of the reserve. If the tertiary costs do not enhance the recovery process, they will be expensed.

D. Qualified Research & Development Credit

Existing federal law allows taxpayers a research credit in the amount of 20% of the excess qualified research expenses. The research credit is designed to encourage companies to increase research and development activities.

To qualify for the credit, research expenses must qualify as an expense or be subject to amortization, be incurred in the U.S., and be paid by the taxpayer. The research must be experimental or laboratory research and pass a three-part test as follows:

1. Research must be undertaken to discover information that is technological in nature. The research must rely on the principles of physical, biological, engineering, or computer sciences.
2. Substantially all of the research activities must involve experimentation relating to quality or to a new or improved function or performance.
3. The application of the research must be intended for developing a new or improved business component. This is a product, process, technique, formula, or invention to be sold, leased, or licensed, or used by the taxpayer in a trade or business.

Ineligible expenses include seasonal design factors; efficiency surveys; management studies; market research; routine data control; routine quality control testing or inspection; expenses incurred after production; or development of any plant, process, machinery, or technique for the commercial production of a business component unless the process is technologically new or improved.

The federal credit does not apply to any expenses paid or incurred after December 31, 2007.

California conforms to the federal credit with the following modifications:

- The state credit is not combined with other business credits.
- Research must be conducted in California.
- The credit percentage for qualified research expenses in California is 15% versus the 20% federal credit.
- The credit percentage for basic research payments in California, limited to corporations, is 24% versus the 20% federal credit.
- The California alternative incremental research expense credit (AIRC) rates are 1.49%, 1.98%, and 2.48% versus the federal rates of 3%, 4%, and 5%, respectively.

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[7] IRC section 212.78(c)(1) through (9) of the June 1979 Energy Regulations, 10 CFT 212.78 (1979).
[8] IRC section 193.

The California research credit is allowed for taxable years beginning on or after January 1, 1987, and is permanent without regard to whether the federal credit is operative.

THIS BILL

This bill would provide a credit for taxable years beginning on or after January 1, 2011, and before January 1, 2016, in an amount equal to 50% for clean energy technology equipment. This credit will be limited to $10 million.

This bill would define "clean energy technology" to mean an energy supply or end-use technology that meets all of the following:

1. Is reliable, affordable, economically viable, socially acceptable, and compatible with the needs and norms of California and the United States,
2. Results in reduced emissions of greenhouse gases, increased geological sequestration, or energy efficiency, and
3. May substantially lower emissions of air pollutants and generate substantially smaller or less hazardous quantities of solid or liquid waste.

This bill would define "qualified amount" to mean the total amount paid or incurred by the qualified taxpayer for either of the following:

- Machinery, equipment, or devices, or any addition to, reconstruction of, or improvement of, machinery, equipment, or devices that are acquired, constructed, or installed in connection with the processing or manufacturing of clean energy technology that are located and remain within California, or
- Capital investments in a qualified facility.

This bill would define "qualified facility" to mean a facility that meets both of the following:

1. The qualified taxpayer has provided the California Energy Commission with all the pertinent information needed to certify (item #2) the facility and remitted any certification fees to the California Energy Commission, and
2. The California Energy Commission has certified the facility as a facility where all of the processed or manufactured items are clean energy technology.

This bill would define "qualified taxpayer" to mean a taxpayer that is engaged in those lines of business according to the North American Industrial Classification System (NAICS) and that has been engaged in the processing or manufacturing of clean energy technology products in this state for five years or less.

This bill would require the Franchise Tax Board (FTB) to promulgate rules and regulations necessary to establish procedures, processes, requirements, and rules required to implement the provisions of this bill.

This bill would allow the carryover of the unused credit until the credit amount is exhausted.

This bill would make the following changes to certain incentives for taxpayers engaged in the business of oil production:

- A repeal date of January 1, 2017, would be specified for the credit provided in this bill.
- A taxpayer engaged in the business of oil production would be prohibited from claiming the qualified research and development credit (R&D) allowed under current state law.
- The enhanced oil recovery credit for taxpayers engaged in the business of oil production would be repealed.
- As drafted, this bill would continue to allow any oil producer from claiming IDCs.
- A taxpayer engaged in the business of oil production would be specifically disallowed from claiming the depletion deduction allowed under current state law.

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.

This bill would provide a credit for taxable years beginning on or after January 1, 2011, and before January 1, 2016, and limits the amount of credit. It is unclear whether the limit is per year or per taxpayer. Clarification of this issue would prevent disputes between taxpayers and the department.

This bill is silent about whether the property must be purchased "new" or whether used property would also qualify. Because the credit is not limited to new property, the original use of which commences with the taxpayer, taxpayers could sell the property among affiliates and, absent any kind of recapture provision, continually generate new credits. The author may wish to add a recapture mechanism that requires the taxpayer to use the qualified property for a minimum period in order to qualify for the credit.

This bill is silent about who would regulate and certify if a taxpayer met the definition of "qualified amount" for clean technology equipment. To prevent disputes between taxpayers and the department, the author may want to amend the language of the bill to require the California Energy Commission to determine the required standard.

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 because experience shows credits typically are exhausted within eight years of being earned.

This bill does not specify how long the clean energy technology equipment needs to remain within California and what would happen if the time limit is not met. To prevent disputes between taxpayers and the department, the author may want to clarify for how long the equipment needs to remain in California and what kind of remedy will take place if the time limit is not met by the taxpayer.

This bill requires the California Energy Commission to certify the facility as a facility where all of the processed or manufactured items are clean energy technology. The author may want to add the provision requiring the taxpayers to provide the certification upon request from the FTB to help the department administer this bill.

This bill specifies that a “qualified taxpayer” means a taxpayer who is engaged in the processing or manufacture of clean energy technology products in this state for five years or less. The department would be unable to administer the required time limit. Clarification is necessary on how and who will be responsible for tracking the time limit provision in this bill.

This bill defines a “qualified taxpayer” to mean a taxpayer that is engaged in those lines of business according to the NAICS. The author may want to clarify the phrase “engaged in those lines of business” to prevent disputes between taxpayers and the department.

The term “oil production” in this bill is unclear and undefined. To prevent disputes between taxpayers and the department, the department recommends that the term be defined.

TECHNICAL CONSIDERATIONS

The amendment made to Revenue and Taxation Code (R&TC) section 17260 (b) could be interpreted to disallow the 40% expense deduction for property placed in service in an enterprise zone. If author’s intention is to disallow the IDC, subdivision (c) should be added under current R&TC section 17260 to specifically disallow that credit.

Reference in corporate tax law to IRC section 263 is technically flawed because California has parallel, stand-alone language in R&TC sections 24422 and 24423. If the author’s intention is to conform to IRC section 263, it is suggested that R&TC sections 24422 and 24423 be repealed and the bill’s section 24423 be modified to substitute appropriate state cross-references.

LEGISLATIVE HISTORY

AB 811 (Levine, 2007/2008) would authorize a credit for amounts paid or incurred for the construction of an eligible renewable resource. AB 811 is currently in the Assembly Rules Committee.

AB 1285 (Parra, 2007/2008) would have allowed a qualified research expense credit for an amount paid or incurred to develop technologies to reduce greenhouse gas emissions. This bill failed to pass out of the first house by January 31 of the second year of the session.

AB 1527 (Arambula, 2007/2008) would create two marketable tax credits relating to the clean technology industry. This bill failed to pass out of the first house by January 31 of the second year of the session.

AB 1651 (Arambula, 2007/2008) would have enacted a tax credit for equipment used to reduce greenhouse gas emissions. This bill failed to pass out of the first house by January 31 of the second year of the session.

AB 2924 (Arambula, 2005/2006) would have: (1) allowed three new credits for certain capital expenditures, and (2) permitted accelerated depreciation of the expenditures. AB 2924 was held in the Assembly Revenue & Taxation Committee.

OTHER STATES' INFORMATION

The states surveyed include *Illinois, Massachusetts, Michigan,* and *New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. The survey was limited to income or franchise tax benefits related to manufacturing equipment.

Illinois provided a replacement tax investment credit equal to 0.5% of the basis of qualified property placed in service during the tax year (from July 1, 1984 to January 1, 2004) used by a taxpayer primarily engaged in manufacturing, retailing, coal mining, or fluorite mining.

Massachusetts provides a 3% credit based on the cost of qualified property used for manufacturing, farming, fishing, or research and development. In 2003 Massachusetts made its investment tax credit permanent.

Michigan provided a credit (from December 31, 2004 and before January 1, 2006) of up to 2% to taxpayers with gross receipts of $10 million or less for newly created high-technology activities or manufacturing jobs.

New York provides an investment tax credit to manufacturers for certain depreciable equipment or buildings. Taxpayers determine the amount of the credit by calculating a percentage of the credit base. The percentage used to compute the credit depends on the period during which the property was acquired, constructed, reconstructed, or erected. For example, for tax years beginning in 1987, the credit is 5% of up to $350 million of qualified expenditures and 4% for qualified expenditures in excess of $350 million. Certified pollution control, industrial waste treatment, and acid rain control facilities also qualify for this credit. Research and development property may qualify for an optional rate of 9%.

FISCAL IMPACT

If the bill is amended to resolve the Implementation and Technical considerations addressed in this analysis, the department's costs are expected to be minor.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue effects:

Revenue Impact of SB 1484 As Amended March 28, 2008 Enactment Assumed After June 30, 2008 ($ in Millions)					
	2008-09	2009-10	2010-11	2011-12	2012-13
Clean Energy Technology Credit			–$160	–$525	–$640
Repeal of R&D Credit for Oil Companies	Gain of less than $0.15	Gain of less than $0.15	Gain of less than $0.15	Gain of less than $0.15	Gain of less than $0.15
Repeal Percentage Depletion Deductions	+$22	+$20	+$20	+$20	+$20
Total	+$22	+$20	–$140	–$505	–$620

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill. The numbers in the table above have been adjusted to reflect revenue estimates for fiscal years.

Revenue Discussion

According to the Census Bureau, the total amount of capital expenditures in 2006 was $761 billion. Applying the projected corporate profit growth rates from the Governor’s Budget, this amount would increase to approximately $1 trillion in 2011.

Clean Energy Technology Credit:

According to the same source, the amount of 2005 spending on pollution abatement technologies was approximately 1% of total capital expenditures. Due to the incentive of allowing a credit provided in this bill, it is assumed that this ratio would increase to 2%. This assumption was based on the speculation that companies, such as management consulting firms or real-estate offices, would not have sufficient available resources to install energy-saving technologies. Based on this assumption, the amount spent on clean-energy technologies would be $20 billion ($1 trillion x 2%). For purposes of an estimate for this bill, it is assumed that California’s share would be 10% or $2 billion ($20 billion x 10%). With a credit equal to 50% of the qualified costs related to clean energy technology, this amount would be reduced to $1 billion. It is further estimated that only 75% of this amount can be claimed due to the $10 million limitation specified in this bill, which would result in the total credit for this bill of $750 million ($2 billion x 50% x 75%). It is assumed that 70% of $750 million, approximately $500 million, could be used due to sufficient tax liability.

Enhanced Oil Recovery Credit:

The amount of enhanced oil recovery credit for 2011 was projected to be $0. For 2006 and later years, the “reference price” (the average per barrel wellhead price of domestic crude oil) of oil has exceeded $28 (as indexed for inflation) and thus this credit is completely phased out.

R & D Credit:

Based on a review of tax return data, the impact of the elimination of the R&D credit for oil companies is estimated to be very small, less than $150,000 for each year.

Percentage Depletion Deduction:

The repeal of percentage depletion deductions is estimated to raise $19 million of revenue in 2008. This amount is estimated to increase at the corporate profit growth rate in subsequent years reaching $20 million in 2011. The estimates include the effect of the repeal on the credits claimed by oil companies only and exclude natural gas and mineral companies.

IDCs:

As drafted, the bill continues to allow accelerated depreciation of IDCs. As a result, these costs are not included in the revenue estimates above. The potential effect of repealing this provision would be in excess of $10 million per year.

Summary:

The net effect of the provisions in this bill in 2011, therefore, would equal $480 million ($500 million from Clean Energy Technology Credit – $20 million from Repeal of Percentage Depletion Deduction = $480 million). The department estimates the revenue impact would be increased by 5% to include personal income taxpayers. Taxable year estimates are converted to fiscal year estimates in the table above

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