

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: McPherson Analyst: Colin Stevens Bill Number: SB 229

Related Bills: See Legislative History Telephone: 845-3036 Introduced Date: 1/25/99

Attorney: Doug Bramhall Sponsor: _____

SUBJECT: Irrigation Equipment Credit

SUMMARY

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), this bill would allow a tax credit equal to 15% of the cost to purchase and install qualified water application or distribution equipment that provides water conservation or savings. The equipment must be used for the production of farm income on agricultural land owned or leased by the taxpayer in this state. The credit for a parcel of land would not exceed the lesser of \$1,000 per acre of land served by the qualified equipment or \$1 million.

EFFECTIVE DATE

This bill is a tax levy and would be effective immediately upon enactment. The bill would apply to taxable or income years beginning on or after January 1, 1999, and before January 1, 2004.

LEGISLATIVE HISTORY

AB 1081, SB 1402 (1998), AB 1585, AB 188 (95/96), AB 2759 (1994); AB 710 (1993); AB 3375 (1990); AB 1701 (1989); SB 1034 (Stats. 1977, Ch. 1100)

BACKGROUND

A similar tax credit for the purchase and installation of water irrigation systems expired on December 31, 1985. That credit, taken in the year of installation, was the lesser of 10% of the cost or a maximum of \$500 and was provided in addition to any other qualified deductions.

SPECIFIC FINDINGS

Existing state and federal laws generally allow a depreciation deduction for the obsolescence or wear and tear of property used in a business or as investment property. The property must have a limited, useful life of more than one year and includes equipment, machinery, vehicles and buildings, but excludes land. Property is assigned to specific classifications related to the number of years of its useful life. The property then may be depreciated over the number of years of its useful life (recovery period).

Existing state and federal laws allow a taxpayer to deduct expenses paid or incurred in the ordinary course of a taxpayer's business. Expenses related to water conservation qualify to the extent that they are ordinary and necessary business expenses and are not for the purchase of property with a useful life of more than one year.

Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ X PENDING

Department Director

Date

Gerald Goldberg

3/9/1999

Existing state and federal laws allow taxpayers to use various credits against tax. Neither state nor federal law currently has a tax credit similar to the one proposed by this bill.

This bill would allow taxpayers that own or lease agricultural land to take a tax credit for costs paid or incurred for purchasing and installing qualified water application or distribution equipment. The equipment in the taxable year of installation must conserve or save at least 10% in comparison to the water used on the same land during the prior taxable year.

This bill would define "qualified water application or distribution equipment"; "water conservation or savings"; "agricultural land"; "land served"; and "parcel of land."

No credit would be allowed unless an "independent" registered civil engineer, registered agricultural engineer, or certified irrigation designer, independent of the purchaser, seller or manufacturer of the equipment, certifies to the taxpayer prior to the purchase that the equipment meets the required water conservation or savings.

The taxpayer would be required to provide that certification to the Franchise Tax Board (FTB) upon request.

The excess credit could be carried over indefinitely to reduce the taxpayer's tax liability in future years. However, any carryover credit in the next year or subsequent years would be disallowed if the taxpayer sells the land on which the qualified equipment was installed.

The basis of the qualified equipment would be reduced by the amount of the allowable credit.

Policy Considerations

Because this bill requires an adjustment to basis, it would create a state and federal difference and would increase the complexity of tax preparation. However, disallowing the adjustment would mean that the taxpayer would receive a double tax benefit with respect to the same expenses.

With respect to the credit recapture provision, this bill would provide disparate treatment to taxpayers depending upon their status as a landowner or a lessee of farmland. For example, this bill would eliminate the credit carryover of a taxpayer who purchases qualified water application equipment and then sells the land on which the qualified water application equipment had been installed, but would allow a credit carryover to a taxpayer who is leasing the same land and terminates their lease, even if the qualified water application equipment is removed from the leased property. Moreover, a taxpayer who is able to fully utilize the credit in the year of installation, for example, suffers no penalty should the property be sold the following year.

Implementation Considerations

The following implementation concerns have been identified. Department staff is available to work with the author's office to resolve these concerns.

It is unclear what is meant by "receive the credit once." The term could mean that a taxpayer could receive, in the aggregate over a lifetime, no more than \$1 million (or \$1,000/acre) regardless of how many parcels of land are owned or could apply to each parcel. Or the limitation could mean that the taxpayer could claim a credit only for one year. In that case, if water conservation equipment were installed in 1999 on one parcel, and a credit claimed that year, no credit would be available for equipment installed in future years.

Items that may be included in the cost of the equipment and installation are not identified. Without more specific guidelines, administration of the credit would be difficult. For example, it is unclear if the cost of obtaining the certification would be included in the cost of installation.

The phrase "independent of" is a subjective standard and may be open to interpretation. To clarify the term and eliminate differences in interpretation, the language should specify an objective relationship standard. Providing an objective relationship standard would make it clear that the certifying civil engineer, registered agricultural engineer or certified irrigation designer may not be an employee or otherwise related to the purchaser, seller or manufacturer of the water application or distribution equipment.

The bill would require water conservation or savings of at least 10% in comparison to the water used on the agricultural land in the prior taxable or income year. Arguably, water conservation equipment installed on land that has lain fallow or currently has no irrigation system would not be eligible for the credit if the use of a water application or distribution system actually would increase the amount of water used on the land. This credit does not limit the carryover period. Current policy has been to provide a limited carryover period for most credits since carryovers are typically exhausted in eight years.

FISCAL IMPACT

Departmental Costs

If the implementation concerns are resolved, this bill is not expected to result in significant costs to the department.

Tax Revenue Estimate

The estimated revenue impact PIT and B&CT revenue are shown in the following table.

Estimated Revenue Impact of SB 229			
Fiscal Year Cash Flow			
Income/Taxable Years Beginning After December 31, 1998			
Enactment Assumed After June 30, 1999			
\$ Millions			
1999-2000	2000-1	2001-2	2002-3
(\$4)	(\$6)	(\$7)	(\$7)

This analysis excludes crop rotation from high water to low water use as a way of qualifying less efficient technology for the credits. Any changes in employment, personal income, or gross state product that could result from this measure are not considered.

Tax Revenue Discussion

This estimate was developed in several steps. First, according to the 1997 California Statistical Abstract, approximately 9 million acres are irrigated annually in California. Second, according to the Department of Water Resources (DWR) 30-year projections of irrigated acres in California, approximately 40% of statewide acreage of irrigated farmland would be irrigated by qualified technology, i.e. sprinkler, drip, and subsurface drip irrigation methods. Applying this percentage to the total number of irrigated acres in California, it was projected that approximately 3.6 million qualified acres would adopt water saving technology. Third, from discussions with industry representatives, it was concluded that the average life of water savings equipment is about 15 years. Thus, in a given year approximately 1/15th of the estimated irrigated land would replace and invest in water technology. Fourth, the average cost per acre to install the equipment was calculated at \$505 per acre for 1999. Fifth, the total expenditures were calculated based on the cost of equipment, and a 15% credit was applied to arrive at total qualified credit amounts. The applied credit amounts were adjusted to account for the reduction in depreciation that would result from the use of the credits. Based on projections for agricultural land use, a negative two-tenths of a percent per year growth rate was used to adjust the total number of acres irrigated. The portion of credits that could be applied in any given year was estimated using tax returns that report farm income. It was assumed that unapplied carryover credits would be exhausted by the fourth year.

BOARD POSITION

Pending.