



## Analysis of Amended Bill

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Sponsor:

Bill Number: AB 2042

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Introduced: February 6, 2018 &  
Amended: March 19, 2018

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Related Bills: See Legislative  
History

**Subject:** Residential Graywater Reuse System Credit

### Summary

This bill would, under the Personal Income Tax Law (PITL), allow a tax credit to taxpayers that install residential graywater reuse systems.

**Recommendation – No position.**

### Summary of Amendments

The March 19, 2018, amendments removed legislative intent language related to financial incentives for homeowners and added the provisions discussed in this analysis.

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

### Reason for the Bill

The reason for the bill is to promote water conservation and reduce homeowners' water bills by incentivizing the purchase of graywater reuse systems.

### Effective/Operative Date

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for each taxable year beginning on or after January 1, 2019, and before January 1, 2024.

### 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. There are currently no federal or state credits comparable to the credit this bill would create.

Under Revenue and Taxation Code (R&TC) section 41, legislation that would create a new tax credit is required to include specific goals, purposes, objectives, and performance measures to allow the Legislature to evaluate the credit's effectiveness.

### **This Bill**

For each taxable year beginning on or after January 1, 2019, and ending before January 1, 2024, this bill would, under the PITL, allow each resident who is not a dependent of another taxpayer a tax credit of 25 percent of the cost not to exceed \$1,000, of installing a residential graywater reuse system during the taxable year in the taxpayer's residence located in this state.

This bill includes the following credit limitations:

- The credit would be limited to \$1,000 per residence as evidenced by the receipt issued by the Franchise Tax Board (FTB).
- The person that provides the residential graywater reuse system would be required to furnish to the taxpayer an accounting of the system's cost.
- The credit could be claimed once per taxable year.
- Credit in excess of the "net tax," as defined by Section 17039, could be carried over for up to six years, until exhausted.
- For married individuals filing separate returns, the credit would be limited to one-half the amount that could be claimed on a joint return.
- The credit would be claimed in lieu of any depreciation deduction that would be otherwise allowed for the residential graywater reuse system.
- The residential graywater reuse system and its installation would be required to comply with State Water Resources Control Board rules.
- A graywater stub out installed by the home builder prior to the taxpayer obtaining title to the underlying property would be ineligible for this credit.

Beginning on and after January 1, 2019, the FTB would be required to:

- Receive and evaluate applications for the residential graywater reuse system credit submitted by taxpayers.
- Prescribe the form of the application which must include:
  - The applicant's name, address, and social security number or federal employer identification number of the applicant;
  - The amount of the cost of the residential graywater reuse system;
  - The amount for which the credit is claimed; and
  - Any additional information that the FTB requires.
- Review each application received and certify to the taxpayer the credit amount authorized and that the credit amount is less than the annual certification limit of \$250,000 per calendar year.

- Authorize credits in the order of the date the application is received if the qualifying applications exceed the \$250,000 calendar year limit.
- Limit a credit that would, if authorized, exceed the limit, to the amount remaining to reach the \$250,000 calendar year limit.
- Deny subsequent applications received in that calendar year that, if authorized, would exceed the \$250,000 limit.

The FTB would be prohibited from authorizing tax credits in excess of the \$250,000 limit in the event that amounts previously certified for the calendar year are unclaimed or a taxpayer fails to meet the requirements to claim the additional credit.

The FTB would be allowed to verify that a residential graywater reuse system has been installed in the taxpayer's residence.

This bill would define the term "residential graywater reuse system" as meaning a system or a series of components or mechanisms that are designed to provide for the collection of residential graywater and includes a system that is capable of storing residential graywater for future use and reusing the collected water for the same residential property.

This bill includes off code language stating the specific goals, purposes, objectives, and performance measures, as required by R&TC section 41.

### **Implementation Considerations**

Department staff has identified the following implementation considerations for purposes of a high-level discussion; additional concerns may be identified as the bill moves through the legislative process. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

This bill uses terms that are undefined, i.e., "resident," "residence," and "receipt." The absence of definitions to clarify these terms could lead to disputes with taxpayers and would complicate the administration of this bill. The author may want to amend the bill to clearly define the terms.

Because the bill fails to specify otherwise, the credit could be reported on either an originally filed return or an amended return, thus allowing taxpayers to file an amended return, as allowed by statute, to modify the claimed credit. As a result, the aggregate use of the credit could fall below the annual allocation limit.

Because this bill is silent on the applicability of the underpayment penalties, a taxpayer denied the credit because the aggregate credit limit had been reached would be subject to these penalties. If this is contrary to the author's intent, this bill should be amended.

The credit would be allowed to each resident, as specified. Generally income tax credits are allowed to a "taxpayer" or "qualified taxpayer" as defined. For clarity and internal harmony within the R&TC, it is recommended that the bill be amended to use one of the more commonly used terms.

The credit would be allowed “against the taxes imposed by this part” which includes all taxes imposed under the PITL. For example, the annual tax or fee imposed on certain business entities subject to tax is imposed under the PITL. If the author intends that this credit be allowed to individual taxpayers that are subject to the income tax imposed under the PITL, this bill should be amended to replace “against the taxes imposed by this part” with “as a credit against the “net tax,” as defined in Section 17039.”

The provision that would limit the credit to installations in “the taxpayer’s residence located in this state” is inconsistent with the provision that would allow the credit in lieu of depreciation. If the author intends that the credit would be available based on installations of residential graywater reuse systems in rental properties, this bill should be amended.

This bill would require the FTB to receive, evaluate, and certify applications for the credit allowed under its terms. The department lacks expertise with regard to residential graywater reuse systems and installation rules adopted by the State Water Resources Control Board. Typically, credits involving areas for which the department lacks expertise are certified by another agency or agencies that possess the relevant expertise. The certification language would specify the responsibilities of both the certifying agency and the taxpayer.

For speed and ease of administration and taxpayer certainty, the author may wish to consider amending this bill to:

- Limit the credit to amounts claimed on a timely original return;
- Exclude the FTB’s determinations from any administrative or judicial review process. For example, the determination of “first-to-file;”
- Specify that a disallowance of the credit shall be treated as a math error;
- Specify that the FTB may prescribe rules, guidelines, or procedures necessary and appropriate; and
- Exclude the rules, guidelines, or procedures regulations from the Administrative Procedures Act.

## Legislative History

AB 1132 (Berryhill and Huffman, 2007/2008), would have allowed an income and franchise tax credit for a percentage of the costs paid or incurred to install in California an irrigation system that utilizes graywater. AB 1132 failed to pass by the constitutional deadline.

## Other States’ Information

Review of *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York* laws found no comparable tax credits or deductions. These states were selected and reviewed due to their similarities to California’s economy, business entity types, and tax laws.

For tax years after December 31, 2006, and before January 1, 2012, *Arizona* had both an individual and a corporation tax credit for water conservation purposes. The individual income tax credit was for costs associated with installing a water conservation system in the taxpayer’s residence located in *Arizona*. This credit was the lesser of 25 percent of the cost of the system

or \$1,000. The Arizona Department of Revenue was required to review applications received after taxpayers purchased and installed the systems, grant the credits in the order received, and certify a maximum credit amount of \$250,000 per calendar year.

### **Fiscal Impact**

Department staff is unable to determine the costs to administer this bill until the implementation concerns have been resolved. As the bill moves through the legislative process, costs will be identified.

### **Economic Impact**

#### Revenue Estimate

This bill would result in the following revenue loss:

Estimated Revenue Impact of AB 2042 as Amended March 19, 2018  
For Taxable Years Beginning On or After January 1, 2019, and Before January 1, 2024  
Assumed Enactment after June 30, 2018

Fiscal Year	Revenue
2018-2019	- \$100,000
2019-2020	- \$200,000
2020-2021	- \$250,000

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill or for the net final payment method of accrual.

#### Revenue Discussion

Based on data from non-profit organizations and university studies, the average estimated cost to install a residential graywater reuse system for a single unit residence would be \$6,000 and \$200,000 for a multi-unit residence. Because the credit is limited to 25 percent of the cost of installation or \$1,000 per system installed, it is assumed that each taxpayer would generate the maximum credit amount of \$1,000. Because the allocation is limited to \$250,000 per year, the maximum number of taxpayers able to claim the credit would be 250. It is assumed that 75 percent of taxpayers installing graywater reuse systems would learn of the credit in 2019. It is further assumed that taxpayers would be able use the full credit amount in the year generated, resulting in an estimated credit used of \$188,000 in 2019.

For taxpayers who would be allowed to claim business expenses, the credit allowed is in lieu of any depreciation expense otherwise allowed under current law. It is assumed that less than one percent of taxpayers would claim the credit in lieu of depreciation expense, resulting in a negligible offsetting revenue gain.

The estimates are converted to fiscal-year estimates as reflected in the amounts in the above table.

### **Legal Impact**

Limiting this credit to residents may be unconstitutional under the Commerce Clause of the U.S. Constitution. This may be avoided by correcting the definitions (see Implementation Considerations).

### **Support/Opposition**

Support: None provided.

Opposition: None provided.

### **Arguments**

Proponents: Some may argue that this bill would support the state's drought mitigation efforts by making residential graywater reuse systems more affordable for California's homeowners.

Opponents: Some may argue that the credit amount and limitations in this bill do not provide a significant impact towards making residential graywater reuse systems more affordable.

### **Legislative Staff Contact**

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