STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced:	**01/17/07**	Bill No:	**SB 74**
Tax:	**Sales and Use**	Author:	**Florez**
Related Bills:	**AB 307 (Hayashi)** **AB 493 (Ruskin)** **AB 846 (Blakeslee)** **AB 1190 (Horton, et al.)**		

BILL SUMMARY

This bill would, among other things, provide a state (5.25 percent) and an optional local and district sales and use tax exemption for purchases of specified tangible personal property by a person that manufactures, processes, or produces biodiesel fuel, as defined, and for sales and purchases of biodiesel fuel.

ANALYSIS

CURRENT LAW

Under existing law, the Sales and Use Tax Law imposes a sales or use tax on the gross receipts from the sale of, and on the sales price of, tangible personal property, unless specifically exempted by statute. Under existing law, sales of fuel, including biodiesel, are generally subject to sales or use tax.

Under current law, entities engaged in activities such as manufacturing biodiesel, that make purchases of equipment and other supplies for use in the conduct of their activities are required to pay tax on their purchases to the same extent as any other person either engaged in business in California or not so engaged. On the other hand, tax does not apply to purchases of tangible personal property that become an ingredient or component part of an item to be resold. For example, the ingredients that make up biodiesel fuel (such as corn oil) that a producer may purchase are not subject to tax because those items become physically incorporated into the fuel sold.

Under the Diesel Fuel Tax Law (Part 31, Division 2 of the Revenue and Taxation Code, commencing with Section 60001), a state excise tax is imposed on diesel fuel. Biodiesel fuel is taxed in the same manner as traditional diesel. In that regard, the state imposes an excise tax of $0.18 per gallon at the first point at which the biodiesel fuel is

- Imported into California for sale, use, or storage,
- Removed from a California refinery,
- Removed from a terminal rack in California, or
- Blended with tax-paid diesel.

This $0.18 state excise tax, however, is excluded from the computation of sales tax.

This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position.

PROPOSED LAW

This bill would add Sections 6377 and 6377.5 to the Sales and Use Tax Law to provide a state (5.25 percent) and local[1] sales and use tax exemption for a five-year period commencing on January 1, 2008, for the sale and purchase of "biodiesel fuel," and for tangible personal property purchased by a "qualified person" which is

- Directly used or consumed in or during the actual manufacturing, processing, or production of biodiesel fuel, or
- Used or consumed in manufacturing, processing, or production of biodiesel fuel if the use or consumption of the property is necessary and essential to comply with certain statutory or regulatory requirements related to public health

The bill would define "qualified person" to mean a person manufacturing, processing, or producing biodiesel fuel. "Biodiesel fuel" is additionally defined in the bill.

The bill would provide that the proposed exemption *would apply* to the taxes imposed under the Bradley-Burns Uniform Local Sales and Use Tax Law and the Transactions and Use Tax Law, unless the local governments vote for the exemption *not to apply*.

The bill, however, would specify that the exemption *would not* apply to the ½ percent sales and use tax imposed under the State Constitution nor to the ½ percent sales and use tax rate imposed under Section 6051.2 and 6201.2.

As a tax levy, the bill would become effective immediately upon enactment, but would apply to sales and purchases made on or after January 1, 2008.

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by its author. The author's office notes that a system of sales tax exemptions on the sale of, and production of, biodiesel will help to promote the retail purchase and use of biodiesel by providing customers a price incentive, encouraging use by those customers that may otherwise not be inclined to use biodiesel. According to the author's office, providing tax credits and exemptions on sales and purchases of equipment used to produce and distribute biodiesel will also promote the development of the infrastructure necessary to increase biodiesel production in California.
2. **What is biodiesel?** Biodiesel is a renewable diesel replacement fuel that is manufactured from domestically produced oils such as soybean oil, recycled cooking oils, or animal fats. To manufacture biodiesel, these fats and oils are chemically reacted with a short chain alcohol (such as methanol) and a catalyst to produce biodiesel and a glycerin co-product. Biodiesel can be used alone (B100) or blended with petroleum diesel in any proportion. The most popular biodiesel blends are B20, B5, or B2. Any diesel engine can operate on these blends with few or no modifications. This measure would only exempt sales and purchases of "B20" or greater blends.

[1] The bill would provide that the local and district taxes would be included within the proposed exemption, unless the local government that would otherwise receive the sales tax revenues votes for the exemption not to apply.

3. **The local government option, if exercised, would eliminate the uniform base of local and district taxes.** The bill would allow local governments to opt into the proposed exemption if they vote to do so. If no local governments opted into the proposed exemption, sales would be exempt at the state rate of 5-1/4%, and subject to tax at a 2% rate. However, if local governments opt into the exemption, California would be left with a variety of differing rates on the sales proposed to be exempted by this bill. Some practical questions would arise as well. For example, if a city doesn't opt into the exemption for its Bradley-Burns tax (1/2%), but a county does (3/4%), does the entire Bradley-Burns tax then go to the county within the city limits? That is, would the offsetting city credit disappear?

   In addition to the likelihood of increased errors on sales and use tax returns, there would be an added burden placed on the retailers making the sales. The retailers would be required to 1) program their computers to allow for a separate rate for the sales proposed to be exempted by this bill, 2) obtain and retain necessary documentation to support any exempt sales, and 3) account for the exempt sales for purposes of properly reporting their sales and use tax obligations to the Board.

   Also, it is unclear whether "local government" would mean the people of the local jurisdiction voting on the measure or the governing body. This should be clarified consistent with the author's intent.

4. **The entities qualifying for the proposed exemption should be clearly defined.** For purposes of the exemption proposed in Section 6377 of the bill, the entities that are intended to qualify for that proposed exemption are not clearly described. The author may wish to use federal classification codes (such as the North American Industry Classification System) to describe the entities that are intended to receive the benefit of the exemption. Some type of reference should be made, since the bill, as drafted, could be interpreted to mean that the exemption would be extended to purchases of qualifying items by any entity engaged even minimally in the activities described. This would not only complicate administration of the provisions, but would likely increase the associated revenue losses.

5. **The bill should be specific on what the terms "processing" or "producing" mean.** For example, would equipment used to transport the biodiesel fuel from the processing plant be included? What about storage tanks or containers used to store biodiesel fuel? Staff will work with the author's office to refine the bill in these areas as it progresses.

6. **Related Legislation.** A number of bills have been introduced to provide a tax incentive for the manufacture of, or the sale and purchase of, environmentally friendly products, as follows:

   AB 307 (Hayashi) would exempt from the sales and use tax a "fuel cell vehicle" or a "fuel cell system" used exclusively for the purpose of upgrading a fuel cell vehicle, sold or leased to a "qualified person."

   AB 493 (Ruskin) would require the State Air Resources Board to implement a clean vehicle incentive program that provides for a schedule of rebates and surcharges for purchases of new motor vehicles based on the vehicle's emissions of greenhouse gases and other criteria, and would authorize the Board of Equalization to collect the surcharge from a dealer, process rebate claims filed through a dealer

and issue rebates to eligible new motor vehicle owners, and refund the amount of surcharge if that motor vehicle is otherwise eligible for a refund.

AB 846 (Blakeslee) would create exemptions from the sales and use tax for low sulfur fuel products used by water common carriers in either the vessel's auxiliary or main engine, under specified conditions.

AB 1190 (Horton & Huffman) would establish a clean fuel incentive to encourage the distribution and sale of fuels that have lower emissions of greenhouse gases. The incentives would be offered in the form of "credits" for cleaner fuels to offset the current fuel taxes, and provide a surcharge to be added to the current fuel taxes for fuels with greater greenhouse gas emissions.

COST ESTIMATE

The Board would incur costs to administer this measure. These costs would be attributable to, among other things, identifying and notifying qualifying entities, auditing claimed amounts, revising sales tax returns, and programming. These notification efforts would continue to occur each time a local government considers whether or not the proposed exemption applies to its jurisdiction so that retailers have assurances of the proper rate of tax. Also, when local governments opt out, the Board would experience additional workload relative to return processing since partial exemptions require manual processing. The amount of additional workload would depend on the number of taxpayers' returns claiming the exemption. An estimate of these costs is pending.

REVENUE ESTIMATE

BACKGROUND, METHODOLOGY, AND ASSUMPTIONS

The measure defines biodiesel fuel as any motor fuel or mixture of motor fuel that is:

- *Derived wholly or partly from agricultural products, vegetable oils, recycled greases or animal fats, or the wastes of those products or fats*
- *The fuel is a mix of at least 20% biodiesel.*
- *Advertised, offered for sale, suitable for use, or used as a motor fuel in an internal combustion engine.*

Biodiesel in its pure form is known as B100 but it can also be blended with conventional diesel. The most common blends are B5 (5% biodiesel & 95% diesel) and B20 (20% biodiesel & 80% diesel). Currently, biodiesel is taxed as diesel fuel and that tax is applied when fuel is manufactured or imported, which is normally in its pure form (B100 or B00).

Looking at biodiesel sales, the National Biodiesel Board (NBB), a national trade association representing the biodiesel industry, shows a continuous growth in US sales in the last 5 years.

Estimated U.S. Bodiesel Sales:

- 2002 - 15 million gallons

- 2003 - 20 million gallons
- 2004 - 25 million gallons
- 2005 - 75 million gallons
- 2006 - 250 million gallons

As of January 2007, NBB data shows 105 companies or plants actively producing biodiesel in the US; there were seven companies engaged in production in California. Further, there were four plants under construction in California targeted to open in early 2007.

Biodiesel Fuel Sales - California

The Board's Fuels Division indicated that in 2006, suppliers reported 36 million gallons of biodiesel fuel (25 million gallons clear, 11 million gallons dyed) and that this would account for most commercially produced or imported biodiesel diesel. In our discussions with the California Energy Commission (Commission), they estimated that California biodiesel consumption in 2006 was 43 million gallons. This difference is probably due to tracking fuel in different ways for different purposes. Estimated consumption for 2007 is 225 million gallons.

In relation to the proposed exemption period January 1, 2008 to January 1, 2013, the Commission provided the following estimate:

California Biodiesel Consumption Estimate 2008-2012
(millions of gallons)

	In State Production	Imported to CA	Total CA Demand
2008	75	175	250
2009	90	200	290
2010	100	200	300
2011	120	200	320
2012	150	200	350

Based on the above five-year period, average annual biodiesel fuel consumption is estimated to be 302 million gallons. The Commission estimates that 50% of the biodiesel fuel gallons would be B20 grade or higher. Therefore, average annual B20 consumption is estimated to be 151 million gallons.

The Commission indicated that historically, the price per gallon of B20 blend has been about $0.20 higher than conventional diesel, and that this may be due to limited supply and higher demand. It also makes an assumption that continuous increases in biodiesel supply in recent times has probably reduced the difference to about $0.10 per gallon. The Energy Information Administration (EIA) provides weekly retail on-highway diesel prices. Based on the weekly data provided for 2007 for California (April 9th week was the most recent), the average weekly price for 2007 was $2.87. It is estimated that the average price for a gallon of B20 blend in California for the same period would be $2.97 ($2.87 + $0.10 = $2.97).

The average B20 blend price of $2.97 per gallon, as estimated above, includes the California excise tax of $0.18 and the sales and use tax (effective sales tax rate is 7.94%). The California $0.18 excise tax is not subject to the sales and use tax. To estimate the sales price subject to sales tax, we used an average price of $2.57 per gallon that excludes the excise and sales and use tax. Therefore, estimated average annual sales amount to $388 million ($2.57 × 151 million gallons = $388 million).

Tangible Personal Property Expenditures

In our conversations with the Commission, an estimated 20 plants are to begin operations in California in the next two years and the costs of setting up these plants are estimated to be $100 million. The Commission states that if the diesel prices remain high like today and available feedstocks for biodiesel remains competitive, then additional plants from 2009-2012 are likely, and could be at twice the 2007-09 rates. If the diesel fuel prices drop significantly, then the new construction would be appreciably slower. Further, the Commission's assessment is that the markets are likely to maintain current fuel prices then to be appreciably lower over the next to 3-4 years.

If we estimate that average annual costs would be $50 million (the $100 million above is spread over two years) and estimate that 40% would be related to labor costs, estimated annual taxable expenditures that would be exempted by this bill would be $30 million.

REVENUE SUMMARY

The annual revenue loss from exempting $418 million in sales of B20 blend biodiesel fuel and expenditures from the sales and use tax would be as follows:

	Revenue Loss
State loss (5%)	$20.9 million
Fiscal Recovery Fund loss (0.25%)	1.0 million
State loss	$21.9 million
Optional local & district loss	
Local loss (1.00%)	$ 4.2 million
Special District loss (0.69%)	2.9 million
Local loss	$ 7.1 million
Total loss	$29.0 million

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