



**STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS**

DRAFT

Date Amended:	06/19/06	Bill No:	AB 2806
Tax:	Sales and Use	Author:	Hancock
Related Bills:			

BILL SUMMARY

This bill would provide that solar panels and photovoltaic cells included as part of a solar energy system shall be considered materials when furnished and installed in the performance of a construction contract. The bill would specify that these provisions are declaratory of existing law.

Summary of Amendments

The amendment to this bill since the previous analysis adds the provision that specifies that the provisions of the bill are declaratory of existing law.

ANALYSIS

Current Law

Under California’s Sales and Use Tax Law, every person desiring to engage in or conduct business as a seller of tangible personal property within this state is required to apply to the Board for a seller’s permit for each place of business. In general, a seller’s permit must be obtained if a person intends to sell or lease tangible personal property that would ordinarily be subject to sales tax if sold at retail.

The Board’s Regulation 1521, *Construction Contractors*, provides specific guidelines on a contractor’s responsibilities under the Sales and Use Tax Law. Construction contractors are persons who erect, construct, alter, or repair any building or other structure, project, development, or other improvement on or to real property. In general, construction contractors are consumers of the materials and retailers of the fixtures they furnish and install in the performance of a construction contract. As consumers, contractors are generally required to pay tax on their cost of the materials used in the course of the project. With respect to fixtures, contractors are regarded as retailers, and tax applies to their sales of the fixtures.

“Materials” means construction materials and components, and other tangible personal property incorporated into, attached to, or affixed to, real property by contractors in the performance of a construction contract and which, when combined with other tangible personal property, loses its identity to become an integral and inseparable part of the real property. Typical items regarded as materials include asphalt, linoleum, steel, bricks, cement, wallboard, and insulation.

“Fixtures” means items that are accessories to a building or other structure and do not lose their identity as accessories when installed. Items such as air conditioning units, lighting, burglar and fire alarms, prefabricated cabinets, prefabricated counters, elevators, electric generators, and plumbing hardware are typically regarded as fixtures.

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Generally, a construction contractor who simply furnishes and installs materials is not required to obtain a seller's permit with the Board. Contractors that are generally regarded as consumers include, among others, concrete, asphalt or linoleum layers, painters, wallpaper hangers, and window installers. These contractors are generally regarded as consumers of the materials they purchase. If the contractor is liable for use tax on the purchase of the materials, its tax liability is limited to the tax on the purchase price of the materials used in the performance of the contract. If the materials are purchased from a vendor who is responsible for collecting sales tax on the transaction, the contractor may be charged for sales tax reimbursement on the purchase price of the materials.

With regard to a construction contractor that installs fixtures, the contractor's responsibilities are different. A contractor engaged in the business of furnishing and installing fixtures, such as elevators, is generally required to hold a seller's permit, file sales and use tax returns, and remit tax based on his or her selling price of the fixtures he or she installs. The Board's regulation provides that if the contract states the sale price of the fixture, tax applies to that price. However, if the contract does not state the sale price, such as in the case of a lump sum contract, the regulation provides that the sale price shall be deemed to be the contractor's cost price of the fixture.

Contractors that are also the manufacturer of the fixture, however, are required to report tax in another manner. Under the Board's regulation, in such cases where the contractor is also the manufacturer of the fixture, the contractor/manufacturer is required to report tax on his or her "cost price." The "cost price" is deemed to be the price at which similar fixtures in similar quantities ready for installation are sold by him or her to other contractors. If similar fixtures are not sold to other contractors ready for installation, then the cost price shall be deemed to be the amount stated in the price lists, bid sheets or other records of the contractor. If such a price cannot be established, then the "cost price" upon which tax is required to be paid by such contractors/manufacturers is the aggregate of the following:

- Cost of materials, including such items as freight-in and import duties,
- Direct labor, including fringe benefits and payroll taxes,
- Specific factory costs attributable to the fixture,
- Any manufacturer's excise tax,
- Pro rata share of all overhead attributable to the manufacture of the fixture, and
- Reasonable profit from the manufacturing operations which, in the absence of evidence to the contrary, shall be deemed to be 5 percent of the sum of the preceding factors.

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Under existing Property Tax Law, Section 73 of the Revenue and Taxation Code provides an exclusion from property tax assessment for the construction of active solar energy systems, as defined, for use for any of the following:

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- (A) Domestic, recreational, therapeutic, or service water heating.
- (B) Space conditioning.
- (C) Production of electricity.
- (D) Process heat.
- (E) Solar mechanical energy.

The California Personal Income Tax Law and Corporation Tax Law allowed for taxable years beginning on or after January 1, 2001, a 15 percent nonrefundable Solar or Wind Energy System Credit for certain approved photovoltaic or wind-driven solar or wind energy systems. For taxable years beginning on or after January 1, 2004, and before January 1, 2006, the credit percentage changed from 15 percent to 7.5 percent. The credit can be used by taxpayers against the net tax in an amount equal to the lesser of 7.5 percent of the cost paid or incurred for the purchase and installation of a solar or wind energy system after deducting the value of any municipal, state, or federally sponsored financial incentives, or the applicable dollar amount per rated watt of the solar or wind energy system. The last taxable year that this credit may be claimed is 2005. This year, AB 2849 (Ruskin) was introduced to extend the sunset date to January 1, 2011; however, that measure has been held in suspense in the Assembly Revenue and Taxation Committee.

Proposed Law

This bill would add Section 6018.9 to the Sales and Use Tax Law to provide that solar panels and photovoltaic cells included as part of a solar energy system shall be considered materials when furnished and installed in the performance of a construction contract.

The bill would specify that Section 6018.9 is declaratory of existing law.

The provisions of this bill would become effective immediately, but would become operative on the first day of the first calendar quarter commencing more than 90 days after the bill becomes law.

COMMENTS

- 1. Sponsor and Purpose.** This bill is sponsored by the author. According to the author's office, it is intended to eliminate the confusion associated with a contractor's responsibilities to report tax on the installation of solar panels and photovoltaic cells. The author's office notes that currently, construction contractors that furnish and install solar energy systems have a variety of reporting requirements under the Sales and Use Tax Law. Depending on the way the contract for the sale of the solar energy system is written, the contractor is liable to report and remit sales or use tax based on either the contract price or the purchase price of the solar panels or photovoltaic cells. This causes confusion and enforcement issues as the contractor is often not registered with the Board as a "retailer" – which they must be in order to properly report the tax when they furnish and install the solar devices.
- 2. The June 19, 2006 amendments** specify that these provisions are declaratory of existing law.
- 3. These provisions are not entirely declaratory of existing law.** While some roof tiles containing photovoltaic cells have been regarded as "materials" for purposes of the Sales and Use Tax Law (which would be consistent with this bill), solar energy systems have generally been regarded as "fixtures." If the author's intent in

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specifying that this provision is declaratory of existing law is that the bill would have retroactive application, the language should so expressly state (the operative date of the bill also confuses the issue). This is especially important since the Board currently has identified at least one audit that has disclosed unreported tax for a three-year audit period on the sale of solar energy devices (the taxpayer – a manufacturer/contractor - mistakenly regarded the devices as materials, rather than fixtures). If the bill is intended to have retroactive application, the liability disclosed in that audit attributable to these devices would essentially be eliminated. It should be noted, however, that retroactive application of this provision would allow for claims for refund of any tax reported by manufacturers or contractors within the last three years on amounts in excess of the tax due on their cost of materials. This would increase the Board's administrative costs as well as further negatively impact sales and use tax revenues.

4. **This issue is currently under review by the Board's Business Taxes Committee (BTC).** In May 2006, the California Solar Energy Industries Association filed a petition with the Board to amend the Board's Regulation 1521 to achieve the same goal as this measure. The Board heard the petition and referred the issue to the Board's BTC for consideration. The BTC provides a forum for interested members of the public to express their views and present proposals regarding the provisions and policies related to the tax programs administered by the Board. In order to conduct a complete review of the issue, and to provide opportunity for interested parties to participate, it will likely be several months before any proposed regulation change is presented to the Board for consideration for adoption.
5. **What is the effect of this measure?** Essentially, enactment of this measure would place construction contractors (including manufacturers) that furnish and install solar energy panels and photovoltaic cells in the same category as construction contractors that furnish and install materials. They would be regarded as consumers, and their tax liability or their sales tax reimbursement would be measured by the purchase price of the panels and cells. If their contracts are solely limited to these items or other materials and they are not otherwise engaged in business as sellers or retailers, they would no longer be required to hold seller's permits, file sales or use tax returns, or remit tax to the Board on their sales price of the items, regardless of whether their contracts provide for a separate sales price for the items or are billed one lump sum price. Instead, provided the contractors pay all applicable tax or tax reimbursement on their purchase price of the items, they would have no further responsibilities to report tax on these transactions to the Board.
6. **Manufacturers/contractors installing complete solar energy systems may continue to have a reporting obligation to the Board.** The bill would specify that the solar panels and photovoltaic cells portion of a solar energy system would be regarded as materials, rather than fixtures. However, the bill does not include other components typically included within the installation of a complete solar energy system, such as inverters, electrical meters, and fuse boxes, as materials. Consequently, manufacturers/contractors installing these components would continue to be required to file returns with the Board and report the tax on the sale of these items as fixtures.

7. **A definition of “solar energy system” should be included.** In order to minimize any potential audit disputes or confusion, it is recommended that the bill include a definition of “solar energy system” consistent with that used by the State Energy Resources Conservation and Development Commission.
8. **Administration would be simplified; however, bill sets a precedent.** Aside from the question as to whether the bill would have retroactive application, enactment of this measure would simplify the Board’s administration of the Sales and Use Tax Law relative to future transactions, since a distinction as to whether a photovoltaic cell constitutes a material or fixture would no longer be required. However, it would set a precedent with regard to treating construction contractors of solar panels and photovoltaic cells differently than contractors that furnish and install all other sorts of fixtures. Such contractors may believe they are being unjustly treated and may question why the Legislature chose to provide special tax reporting privileges for solar energy system contractors over contractors who furnish and install other sorts of fixtures.

COST ESTIMATE

Some costs would be incurred in reviewing and processing claims for refund, revising the Board’s regulation, notifying affected contractors, and answering inquiries from taxpayers. We expect these administrative costs to be moderate (less than \$50,000).

REVENUE ESTIMATE

Background, Methodology, and Assumptions

This bill would add Section 6018.9 to the Sales and Use Tax Law to provide that solar panels and photovoltaic cells included as part of a solar energy system shall be considered materials when furnished and installed in the performance of a construction contract.

The bill does not define what constitutes a “solar energy system.” However, for the purpose of this estimate, we define “solar energy system” to mean any solar collector or other solar energy device, the primary purpose of which is to provide for the collection, storage, and distribution of solar energy for space heating, space cooling, electric generation, or water heating, that is certified by the State Energy Resources Conservation and Development Commission (Energy Commission).

Since 1999, the Energy Commission’s Renewable Energy Program has provided funding for approximately 12.3 thousand commercial and residential Photovoltaic (PV) solar energy systems at a value of \$447.4 million, an average of \$74.6 million in completed projects per year. The Energy Commission funds approximately 2,046 PV systems that are installed throughout the State each year, at an average cost of \$36,500. In addition, the California Solar Energy Industries Association (CAL SEIA) estimates that approximately 600 solar water heating systems are installed in the state at an average cost of \$3,500, for a total of \$2.1 million (\$3,500 x 600). According to one contractor, solar water heating systems are generally sold as a lump sum contract.

The PV system program is by far the largest solar system program in the state. To comply with the rebate program, the Energy Commission requires contractors to identify on their invoices the quantity, make, and model numbers of major equipment and the

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labor charge for installation. Major equipment makes up approximately 34% of the contract price; this includes a general mark-up of about 30%.

As with solar water heating systems, space heating and space cooling systems do not have the same contract requirements specifying the identification of cost of major equipment on invoices. For the purpose of this estimate, we will assume that all of these contracts are lump sum contracts, and the revenue generated based on tax collected in these transactions will not be affected by this measure.

With the assistance of Deloitte Tax LLP, we conducted a phone survey of PV solar energy systems contractors to estimate the percentage of these contractors that utilize *lump sum contracts* as opposed to *time and material or cost plus contracts*. We found that 10 of the 14 (or 71%) contractors that responded to our survey utilized lump sum contracts. Since lump sum contracts do not state the sales price of fixtures, as stated above, the regulation provides that the sales price shall be deemed to be the contractor’s cost price of the fixture, the same tax treatment given to materials. However, if the contractor is a manufacturer of the fixture, the cost price is deemed to be the price at which similar fixtures in similar quantities ready for installation are sold by him/her to other contractors, or, if this information is not available, the amount stated in the price lists, bid sheets, or other records of the contractor. In determining the cost price of fixtures for a manufacturer/contractor, jobsite fabrication, including assembly labor performed prior to attachment of a fixture structure, and its prorated share of manufacturing overhead, are components often included in the sale price of the fixture. Therefore, while this measure may not directly affect the tax treatment for contracts utilizing lump sum type contracts, the proposed classification of solar panels and photovoltaic cells as materials does affect the tax liability of contractors that are the manufacturer of the fixtures they install. We will address the revenue loss on manufacturer/contractor contracts below.

Based on the result of this phone survey, we estimate that at least 593 (29% x 2,046) out of the 2,046 PV solar energy system contracts funded by the Energy Commission annually would be directly affected by this measure.

Using the information specific to PV solar electric generation systems, for cost-plus and time and material contracts, we determined the revenue impact of classifying solar panels and photovoltaic cells as materials when included as part of a solar energy system and installed in the performance of a construction contract:

Photovoltaic Solar Energy Systems

Annual number of completed projects for cost-plus and time and material contracts affected by this proposal	593
Average project cost	\$ 36,500
Estimated value of major equipment (fixtures) in each project (34% of project cost)	\$ 12,410
Assuming an average markup of 30%	<u>\$ 2,860</u>
Total measure affected my this proposal (593 x \$2,860)	<u>\$1,695,980</u>
 State and local revenue impact	 \$ 134,321

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In addition, under this measure, manufacturers of PV systems that perform construction contracts would no longer be required to report the tax at the cost price (the price at which similar fixtures in similar quantities ready for installation are sold by him or her to other contractors). Instead, the manufacturers would only be required to pay tax on their purchase price of the materials incorporated into the solar panels and PV cells.

We are aware of 20 California manufacturers of PV systems that currently participate in the Energy Commission’s Renewable Program. Most of these manufacturers do not install the PV systems that they manufacture. Rather, they sell them directly to installation contractors or retail sellers. However, we found 6 of these manufacturers that furnish and install PV systems. The value of PV system projects that the Energy Commission has approved utilizing PV modules manufactured by these companies is estimated to be over \$330 million. The revenue loss of this measure could be significantly more than the \$134,000, as much as threefold, or \$400,000 a year. However, because of the complexity of this issue, estimating just how much of an impact this bill will have is difficult to determine without the benefit of an audit of contracts by all manufacturers/contractors.

Revenue Summary

The annual revenue loss associated with classifying solar panels and photovoltaic cells as materials when included as part of a solar energy system and furnished and installed in the performance of a construction contract is as follows:

	Revenue Loss
State (5.00%)	\$252,000
Fiscal Recovery Fund (.25%)	13,000
Local (2.00%)	\$101,000
District (.68%)	\$34,000
Total	\$400,000

However, the proposal specifies that this change is declaratory of existing law. That means, once the bill is enacted, taxpayers may have a right to file claims for refunds, and those claims could apply to the preceding three-year period from the date of the claim. That could amount to at least \$400,000 for each of the applicable three years for a total of \$1.2 million. Therefore, the total estimated revenue loss could amount to as much as \$1.6 million during the first year after enactment of the bill as follows:

	Revenue Loss
State (5.00%)	\$1,008,000
Fiscal Recovery Fund (.25%)	52,000
Local (2.00%)	\$404,000
District (.68%)	\$136,000
Total	\$1,600,000

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