

DRAFT



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

Date Amended:	<b>01/23/06</b>	Bill No:	<b>AB 674</b>
Tax:	<b>Diesel Fuel Tax</b>	Author:	<b>Klehs</b>
Related Bills:			

**BILL SUMMARY**

This bill would revise the method by which the excise tax on clear, undyed (tax-paid) diesel fuel used on a farm for farming purposes is refunded.

**Summary of Amendments**

The amendments since the previous analysis would require the Board of Equalization (Board) to adopt rules and regulations to allow, to the extent practicable, a claim for refund of the state tax on diesel fuel sold to a purchaser for use on a farm for farming purposes to be submitted on the same form submitted to the Internal Revenue Service for a claim of refund of federal tax on diesel fuel sold to a purchaser for use on a farm for farming purposes.

**ANALYSIS**

**Current Law**

Under existing Diesel Fuel Tax Law (Part 31, Division 2 of the Revenue and Taxation Code, commencing with Section 60001), the state imposes an excise tax of \$0.18 per gallon on the removal of diesel fuel at the refinery or terminal rack, upon entry into the state, and upon sale to an unlicensed person, unless specifically exempted.

There are two methods by which farmers may purchase diesel fuel for use on a farm for farming purposes without paying the diesel fuel tax. A farmer may purchase dyed (untaxed) diesel fuel if, among other things, the fuel will be used exclusively for nontaxable, off-highway purposes, such as on a farm, or purchase undyed (tax-paid) diesel fuel from an ultimate vendor without paying the diesel fuel tax, if that fuel will be used on a farm for farming purposes.

**SALES OF DYED DIESEL FUEL FOR USE ON A FARM FOR FARMING PURPOSES**

Specifically exempted from the payment of taxes is diesel fuel that satisfies specified dyeing and marking requirements. Dyed diesel fuel is diesel fuel that is dyed pursuant to United States Environmental Protection Agency (EPA) and Internal Revenue Service (IRS) rules for high sulfur diesel fuel or low sulfur diesel fuel or any other requirements subsequently set by the EPA and the IRS and considered destined for **nontaxable, off-highway uses**. No person may operate or maintain a motor vehicle on any public highway in this state with dyed diesel fuel in the fuel supply tank, unless otherwise specified.

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**SALES OF UNDYED DIESEL FUEL FOR USE ON A FARM FOR FARMING PURPOSES**

Diesel Fuel Tax Law Section 60502.1 provides that an ultimate vendor shall not include diesel fuel tax in the sales price or on the sales invoice for diesel fuel sold to an ultimate purchaser. Under Section 60502, any ultimate vendor who has paid a tax on diesel fuel sold to an ultimate purchaser for use on a farm for farming purposes may be reimbursed for the amount of diesel fuel tax paid. To obtain reimbursement for the amount of diesel fuel tax paid, an ultimate vendor must file a claim for refund with the Board, as specified.

Section 60036 defines an “ultimate vendor” to mean a person that sells undyed diesel fuel to the user of the diesel fuel (the ultimate purchaser) for use on a farm for farming purposes or for use in an exempt bus operation. Section 60037 defines an “ultimate purchaser” to mean a person that uses diesel fuel for use on a farm for farming purposes or an exempt bus operator that uses diesel fuel in an exempt bus operation.

**REFUNDS FOR TAX PAID FOR DIESEL FUEL USED ON A FARM FOR FARMING PURPOSES**

Diesel Fuel Tax Law Section 60501 specifically prohibits any person who has paid a tax on diesel fuel used on a farm for farming purposes or in an exempt bus operation<sup>1</sup> from being reimbursed for the amount of the tax paid through the claim for refund process.

**Proposed Law**

This bill would repeal provisions in the Diesel Fuel Tax Law that permit persons that use diesel fuel for use on a farm for farming purposes to purchase undyed diesel fuel from an ultimate vendor without the payment of diesel fuel tax. If such persons continue to purchase undyed (tax-paid) diesel fuel for use on a farm for farming purposes, they would be required to pay the tax to the vendor and would be permitted to submit a claim for refund to the Board to be reimbursed for the amount of diesel fuel tax paid.

This bill would also require the Board to adopt rules and regulations to allow, to the extent practicable, a claim for refund of the state tax on diesel fuel sold to a purchaser for use on a farm for farming purposes to be submitted on the same form submitted to the Internal Revenue Service for a claim of refund of federal tax on diesel fuel sold to a purchaser for use on a farm for farming purposes.

This bill would become effective January 1, 2007.

**Background**

On August 10, 2005, President Bush signed H.R. 3, which is known as the Safe, Accountable, Flexible, and Efficient Transportation Equity Act of 2005, into Public Law (Public Law No. 109-59). Among other things, Public Law No. 109-59 repealed the federal law that permitted ultimate vendor refund claims with respect to farming. This change in federal law applies to sales after September 30, 2005.

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<sup>1</sup> This bill would not affect these provisions as they relate to exempt bus operations

**COMMENTS**

1. **Sponsor and purpose.** This bill is sponsored by the California Independent Oil Marketers Association (CIOMA) and is intended to conform California's Diesel Fuel Tax Law to federal law. CIOMA states that differing state and federal exemptions "will create a bifurcated system of excise tax exemption between state and federal excise taxes for clear diesel fuel." CIOMA also states that the "situation where the state and federal tax exemption provisions are diametrically opposed will create significant paper work and accounting problems for our members."
2. **Summary of amendments.** The **January 23, 2006**, amendments require the Board to adopt rules and regulations to allow, to the extent practicable, a farmer to submit the same claim for refund form for the state tax for clear, tax-paid diesel fuel used on a farm for farming purposes submitted to the Internal Revenue Service for a claim of refund of federal tax.
3. **This bill should have a delayed operative date.** To effectively implement this bill, it would be necessary for the Board to notify ultimate vendors and ultimate purchasers<sup>2</sup> of the change in law, develop computer programs to allow for agricultural claims for refund and to register those claimants, hire and train key staff, create a claim for refund form and supporting schedules, and answer taxpayer inquiries. These functions should take place before the bill becomes operative. As such, this bill should be amended to provide for a **July 1, 2007**, operative date and to add an appropriation for administrative start-up costs. This would provide the Board with sufficient lead-time and necessary funding to successfully implement the bill.

If the author wants the provisions of this measure to become operative January 1, 2007, the bill should be amended to add an urgency clause and an appropriation.

Without a delayed operative date and appropriate funding, the Board would not be able to notify affected taxpayers and hire appropriate staff to answer telephone inquiries, establish procedures, and develop refund forms in a timely manner. In addition, the Board would not be able to register farmers and process refund claims until the necessary computer programs are developed.

4. **This bill would need to contain a specific appropriation to the Board.** The Board would implement this bill during the current fiscal year regardless of which of the delayed operative dates discussed in Comment #2 is chosen. To cover these administrative start-up costs, the Board would need an adequate appropriation that would not have already been identified in the Board's 2006-07 budget.

Constitutional and statutory provisions prohibit the Board from using special fund appropriations to support the administration of the diesel fuel tax program. Without an appropriation for administrative start-up costs, the Board would have to divert **General Fund** dollars to the diesel fuel tax program, which would have a negative impact on the revenues of State and local government.

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<sup>2</sup> Farmers

As an alternative to an appropriation, the author may want to consider amending the bill to move the operative date to January 1, 2008. This would allow the Board to obtain funding for administrative start-up costs through the Budget Change Proposal process.

**5. Would it be practicable for the Board to accept the IRS claim for refund form?**

This bill would require the Board to adopt rules and regulations to allow, *to the extent practicable*, a farmer to submit to the Board a copy of the Internal Revenue Service claim for refund form for the state tax for undyed (tax-paid) diesel fuel used on a farm for farming purposes.

Although this provision would eliminate paperwork for farmers, it could delay the processing of refunds and increase administrative costs since accepting the IRS claim for refund form would require manual processing by Board staff to identify and label the IRS claim for refund form with the farmer's state account number and to prepare the form into a layout necessary for input into the Board's computer system.

Additional concerns with accepting the IRS forms are as follows:

- Both state and federal statutes require more than seven hundred and fifty dollars (\$750) in tax be refundable for a quarterly claim. But because the state and federal tax rate differ (\$0.18 state / \$0.243 federal), more gallons must be claimed for state purposes to be eligible to submit a quarterly claim for refund. For example: A farmer would be eligible to file a quarterly claim for refund for the federal tax on 3,087 gallons or more of diesel fuel (3,087 gallons x \$.243 federal tax rate = \$750.14). However, it would take 4,167 gallons or more to file a quarterly claim for state purposes (4,167 gallons x \$0.18 state tax rate = \$750.06).
- The IRS claim for refund form does not contain diesel fuel purchase information, which is required and necessary for Board staff to substantiate a claim for refund.
- Multi-state farmers would have to identify the number of gallons of undyed diesel fuel used in California.

It should also be noted that this provision may not capture all farmers that would claim a refund for state tax on tax-paid undyed diesel fuel used on a farm for farming purposes. For federal purposes, the refund of tax is made by either refund payment (Form 8849) or income tax credit (Form 4136). As explained above, a farmer may make a claim for a refund payment for any quarter of a taxable year for which at least \$750 can be claimed. If the farmer cannot claim at least \$750 at the end of quarter, the amount can be carried over to the next quarter to determine if the purchaser can claim at least \$750. If the farmer cannot claim at least \$750 at the end of the taxable year, the farmer must claim a credit on their income tax return. As such, it is questionable whether an income tax credit would qualify as a "form submitted to the [IRS] for a claim of refund of federal tax on diesel fuel sold to a purchaser for use on a farm for farming purposes."

6. **How would this bill impact farmers?** If farmers continue to purchase undyed diesel fuel for off-highway use, they would be required to submit a claim for refund to the Board in order to be refunded the tax on diesel fuel used in a nontaxable manner. Such claims must be filed for a calendar year unless more than seven hundred fifty dollars (\$750) is refundable during a quarter, in which case a claim may be filed for the quarterly period. Since farmers are currently allowed to purchase undyed diesel fuel without the paying the tax, this bill could result in a cash-flow problem for the farmers. This would be especially true for “mom and pop” farmers since they tend to consume relatively small amounts of fuel. Such farmers would likely be limited to an annual claim for refund unless they pay and can claim a refund for more than seven hundred fifty dollars (\$750)<sup>3</sup> in diesel fuel taxes in a calendar quarter.

The cash-flow problem could be avoided if farmers purchase dyed diesel fuel for off-highway purposes. Farmers that only have tanks for undyed diesel fuel may need to convert some tanks to hold dyed diesel fuel or purchase additional storage tanks. In addition, electing to only purchase dyed diesel fuel for off-highway use may not be an option for all farmers. A farmer may still need to buy undyed diesel fuel for a vehicle that is used both on and off-highway, since a vehicle may not be operated on-highway with dyed diesel fuel in the fuel tank. A claim for refund would have to be submitted for reimbursement of the tax paid for any fuel used off-highway.

Opponents to this bill note that farmers would encounter liquidity problems if they continue to purchase tax-paid undyed diesel fuel for nontaxable off-highway use. Even with added Board staff, opponents state that refunds would require several months to process and cause severe cash flow problems for many farmers. Additionally, opponents state that the farmers would have to prove that they are entitled to a refund, requiring additional paperwork, Board audits, and even longer processing time for refunds.

7. **This bill would not be problematic to administer.** At the request of CIOMA, Board staff provided technical assistance in drafting the proposed language. As such, administering the language in this bill would not be problematic for the Board.

## COST ESTIMATE

### Assumptions

Currently, there are approximately 30,500 farmers purchasing undyed diesel fuel from ultimate vendors without paying the diesel fuel tax. For purposes of this cost estimate, Board staff requested CIOMA to survey its membership to gauge how farmers would purchase diesel fuel if this bill were to become law. The survey indicated that 31 percent of their customers (farmers) would continue to purchase undyed diesel fuel and submit a claim for refund for the amount of diesel fuel tax paid for fuel used in a nontaxable use. As such, it is estimated that Board would receive refund claims from 9,455 farmers (30,500 x .31). The claims received for each filing period and annual estimates are as follows:

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<sup>3</sup> Or more than 4,167 gallons of diesel fuel ( $\$750 \text{ refunded tax} / \$0.18 \text{ diesel fuel tax per gallon} = 4,167 \text{ gallons}$ )

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Filing Basis	Number of Taxpayers on Filing Basis	Number of Claims per Year
Quarterly (estimated 20% x 9,455)	1,891	7,564
Semi-Annual (estimated 30% x 9,455)	2,837	5,674
Annually (remaining balance)	4,727	4,727
Total	9,455	17,965

### Administrative Costs

The Board would incur non-absorbable costs to register additional taxpayers, develop computer programs, establish the refund program, revise forms and publications, process and mail additional claims for refund, carry out compliance and audit activities to ensure proper reporting, train staff, and answer inquiries from the public.

Board staff estimated administrative costs based on two operative dates: January 1, 2007, assuming that the bill is an urgency measure and contains an appropriation from the Motor Vehicle Fuel Account, and July 1, 2007, assuming that the bill is a non-urgency measure and contains an appropriation. Both operative date scenarios would provide the Board sufficient lead-time to implement the bill.

Assuming a **January 1, 2007**, operative date, these costs are estimated to be \$1,123,000 for fiscal year 2006-07, \$2,081,000 for fiscal year 2007-08, and \$2,048,000 for fiscal year 2008-09 and each fiscal year thereafter.

Assuming an operative date of **July 1, 2007**, the costs are estimated to be \$277,000 for fiscal year 2006-07, \$2,274,000 for fiscal year 2007-08, and \$2,048,000 for fiscal year 2008-09 and each fiscal year thereafter.

## REVENUE ESTIMATE

### Background, Methodology, and Assumptions

The Fuel Taxes Division conducted only a limited number of farming industry audits during FY 2004-05 because audits of farmers purchasing tax-free clear diesel fuel do not receive the same audit coverage as higher priority taxpayers. However, from the limited numbers of audits performed, Division staff did find that 10% of the diesel fuel purchased ex-tax, and for which a claim for refund was filed by the ultimate vendor, was actually used on-highway and should have been subject to the diesel fuel tax. While the number of audits conducted was very small compared to the total population of farmers in California, staff believes the error rate of 10% is reasonable and assumes that a farmer who today purchases tax-free clear diesel fuel for use in farming operations and uses some of that fuel in a taxable manner without remitting the tax would be less inclined to file a claim for refund directly with the Board and assert that the fuel was used for non-taxable manner. Under this bill, the farmer would file the claim and would have to provide documentation to support his or her off-highway use. In 2004, total refunds to ultimate vendors for clear, undyed (tax-paid) diesel fuel sales to farmers amounted \$36.3 million. Based on an error rate of 10% for unreported on-highway use,

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it is estimated that this bill would increase diesel fuel tax revenue by \$3.6 million (10% x \$36.3 million).

**Revenue Summary**

This bill would increase annual diesel fuel tax revenue by \$3.6 million.

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