HB 366

# Department of Legislative Services

Maryland General Assembly
1999 Session

## FISCAL NOTE
## Revised

House Bill 366 (Delegate Hixson)
(Chairman, Ways and Means Committee)

Ways and Means

### Electric and Gas Utility Tax Reform

This bill alters the taxation of the utility industry to account for the restructuring of the electricity and gas industries. The bill is contingent on the passage of legislation authorizing customer choice in the selection of electric generation suppliers.

Section 1 of this bill takes effect January 1, 2000, and is generally applicable to all taxable years beginning after December 31, 1999. Income tax credits relating to property taxes are allowed for those taxes paid for the property tax year beginning on or after July 1, 2000. The remaining provisions take effect July 1, 1999.

## Fiscal Summary

**State Effect:** General fund revenues would decrease by $1.6 million in FY 2000. In FY 2001 general fund and special fund revenues will increase by $8.0 and $4.8 million, respectively. Future year revenues reflect 3% annual growth in corporate income tax revenues, transmission and distribution gross receipts tax revenues, and kilowatt hour/dekatherm tax revenues. General fund expenditures could increase in FY 2001 by $50,500 for one-time computer programming expenses, $15.3 million for the grants paid to counties for personal property tax relief, and $3.6 million for debt service, for a total of $18.95 million.

| ($ in millions) | FY 2000 | FY 2001 | FY 2002 | FY 2003 | FY 2004 |
|---|---|---|---|---|---|
| GF Revenues | ($1.60) | $8.00 | $9.60 | $11.70 | $13.10 |
| SF Revenues | 3.50 | 4.80 | 5.00 | 5.30 | 5.40 |
| GF Expenditures | 0.00 | 18.95 | 34.30 | 34.40 | 34.50 |
| SF Expenditures | 0.00 | (3.60) | (3.70) | (3.80) | (3.90) |
| Net Effect | $1.90 | ($2.55) | ($16.00) | ($13.60) | ($12.10) |

*Note: ( ) = decrease; GF = general funds; FF = federal funds; SF = special funds; - =indeterminate effect*

**Local Effect:** Local revenues would increase by $0.9 million in FY 2000, and decline by

$20.1 million in FY 2001, which would be offset by the grant of $15.3 million and the increase in highway user fees of $2.2 million in FY 2001, resulting in a decrease of $2.6 million in FY 2001. Because the loss will increase faster than the offsets by FY 2004, the local revenue loss will be $10.5 million.

**Small Business Effect:** Potential minimal.

## Fiscal Analysis

**Bill Summary:** This bill does the following:

*Public Service Company Franchise Tax*

- Narrows the base of the existing gross receipts tax for electric and gas companies by excluding revenues from the sale of electricity or natural gas, thereby only including revenues from the transmission, distribution, and delivery of electricity or natural gas;

- Specifies that competitive and intangible transition charges and other cost recovery mechanisms to recoup transition and other costs are included in the base of the gross receipts tax;

- Imposes a distribution tax as part of the public service company franchise tax measured by kilowatt hours of electricity or dekatherms of natural gas delivered for final consumption in the State;

- Establishes the distribution tax rates at 0.062 cents for each kilowatt hour of electricity delivered and 0.402 cents for each dekatherm of natural gas delivered;

- Provides a cap on the distribution tax for electricity for the largest industrial customers in the form of a credit against the distribution tax; and

- Provides an exemption from the distribution tax for natural gas for industrial customers, in the form of a credit against the distribution tax.

*Corporate Income Tax*

- Imposes the corporate income tax on electric and gas companies by repealing the existing subtraction modification for gross receipts subject to the public service company franchise tax;

- Adjusts the gain or loss on the sale of electric or gas business assets by an amount equal to the difference between the book basis and the federal tax basis of those assets;

- Allows State income tax credits for: (1) 60% of property taxes paid on real property used to generate electricity for sale; and (2) certain multi-jurisdictional electric companies for wages paid, subject to certain limitations;

- Requires an addition modification to federal adjusted income of a corporation for the property tax and wage credits allowed; and

- Alters a "safe harbor" for estimated income tax payments by electric or natural gas companies for a taxable year that begins in calendar 2000. If the public service company pays estimated franchise and income taxes that total to at least the prior year's franchise tax paid, the Comptroller will not impose interest and penalty for estimated income tax payments that total to less than 90% of the final income tax liability.

*Property Tax*

- Reclassifies poles, lines, towers, and cables of a public utility as personal property;

- Provides a 50% exemption for personal property that is machinery or equipment used to generate electricity for sale, phased-in over two years;

- Authorizes the Department of Assessments and Taxation to classify a company as a public utility and provides a definition of "public utility" for property tax purposes; and

- Allocates the cost of the personal property tax exemption among the counties, State, and electricity customers in the State by providing a State grant phased-in over two years to designated counties in specified amounts.

*Sales and Use Tax*

- Alters the definition of "production activity" to clarify that the generation of electricity is only a production activity if produced for sale or for use in another production activity;

- Clarifies the application of the sales tax to charges for delivery services by including transportation services for transmission, distribution, or delivery of electricity or natural gas in the definition of "taxable service";

- Clarifies the exemption for residential sales of energy; and

- Imposes a special use tax on electricity not distributed by a public service company at a rate of 0.062 cents per kilowatt hour, subject to certain exceptions.

*Other Provisions*

- If the Federal Nuclear Regulatory Commission's license for the Calvert Cliffs Nuclear Power Plant expires and is not extended or renewed, a special grant is provided to Calvert County, to be phased out over five years;

- Requires the Public Service Commission to adjust electric and gas utility rates to reflect: (1) the net effect of taxes properly attributable to regulated operations; and (2) surcharging customers for the distribution tax as authorized under the bill; and

- Provides that if the public service company has a tax year for federal income tax purposes that is not the calendar year, the provisions of the bill do not apply until the beginning of the tax year during calendar 2000.

**State Revenues:** The bill restructures the taxation of the electric and natural gas industries to account for the introduction of competition in the electricity and natural gas markets. There are changes to four sources of State revenues: the public service company franchise tax; the corporate income tax; property taxes; and the sales and use tax.

<u>Public Service Company Franchise Tax</u>

*Electricity*

Under current law, electric utilities are subject to a 2% public service company franchise tax on the sale, transmission, or distribution of electricity in the State. This bill separates the existing public service company franchise tax into two parts by: (1) leaving in place the 2% gross receipts tax on transmission and distribution; and (2) replacing the 2% gross receipts tax on sales with a distribution tax imposed at a rate of 0.062 cents per kilowatt hour of electricity delivered in the State. A credit is provided against the distribution tax for the largest industrial customers based upon the level of usage.

Under the bill, removing sales from the tax base subject to the 2% gross receipts tax results in an estimated loss of public service company franchise tax revenues of $27.8 million in fiscal 2000, reflecting half of the impact of tax year 2000. The distribution tax is estimated to increase revenues by $16.7 million in the same year. The combined impact in fiscal 2000 is estimated to be a loss of $11.1 million as shown in the table below. These estimates do not reflect any additional gross receipts tax revenues that may accrue due to the inclusion of stranded costs, competitive transition charges, or any other special charges in the tax base. Future year revenues for the current gross receipts tax and for the restructured tax are expected to grow at a rate of 3% a year.

**Public Service Company Franchise Tax for Electric Utilities**

| **($ in millions)** | **FY 2000** | **FY 2001** | **FY 2002** | **FY 2003** | **FY 2004** |
|---|---|---|---|---|---|
| Current gross receipts tax on sales | ($27.8) | ($53.5) | ($55.1) | ($56.7) | ($58.4) |
| Distribution tax | $16.7 | $37.6 | $38.7 | $39.8 | $40.9 |
| Net change | ($11.1) | ($15.8) | ($16.3) | ($16.9) | ($17.5) |

*Natural Gas*

Deregulation and retail competition have already occurred in Maryland for the natural gas industry. Large customers have been able to purchase natural gas from unregulated gas marketers or brokers since the 1980s. To the extent that a sale of natural gas is made by a non-utility supplier, the sale is not subject to the current public service company franchise tax, only the delivery charge by the local distribution company is subject to the tax. The competitive market for smaller business and residential sales is expanding. As a result, under current law the revenues from the public service company franchise tax for natural gas are estimated to decline for a period of time at a rate of 9% per year.

Similar to electric utilities, natural gas utilities are subject to a 2% public service company franchise tax on the sale and delivery of natural gas in the State. This bill separates the existing public service company franchise tax into two parts by: (1) leaving in place the 2% gross receipts tax on delivery; and (2) replacing the 2% gross receipts tax on sales with a distribution tax imposed at a rate of 0.402 cents per dekatherm of natural gas delivered in the

State.  An exemption from the distribution tax is provided in the form of a credit for natural gas delivered to industrial customers.

Under the bill, removing sales from the tax base subject to the 2% gross receipts tax results in an estimated loss of public service company franchise tax revenues of $3.8 million in fiscal 2000, reflecting half the impact of tax year 2000.  The distribution tax is estimated to increase revenues by $2.4 million in the same year.  The combined impact in fiscal 2000 is estimated to be a loss of $1.4 million as shown in the table below. Future year revenues for the current gross receipts tax and for the restructured tax are expected to grow at a rate of 3% a year.

**Public Service Company Franchise Tax for Natural Gas Utilities**

| ($ in millions) | FY 2000 | FY 2001 | FY 2002 | FY 2003 | FY 2004 |
|---|---|---|---|---|---|
| Current gross receipts tax on sales | ($3.8) | ($6.8) | ($5.4) | ($4.1) | ($2.9) |
| Distribution tax | $2.4 | $5.0 | $5.2 | $5.3 | $6.8 |
| Net change | ($1.4) | ($1.8) | ($0.2) | $1.2 | $2.6 |

The combined effect of the changes in the public service company franchise tax for electric and natural gas utilities is a decrease of $12.4 million in fiscal 2000 as shown in the table below.  All revenues from the public service company franchise tax accrue to the general fund.

**Public Service Company Franchise Tax Changes**

| ($ in millions) | FY 2000 | FY 2001 | FY 2002 | FY 2003 | FY 2004 |
|---|---|---|---|---|---|
| Electric | ($11.1) | ($15.8) | ($16.3) | ($16.9) | ($17.5) |
| Natural gas | ($1.3) | ($1.8) | ($0.2) | $1.2 | $2.6 |
| Total | ($12.4) | ($17.6) | ($16.6) | ($15.7) | ($14.9) |

Corporate Income Tax

*Electricity and Natural Gas*

For State corporate income tax purposes, electric and natural gas utilities are currently allowed to subtract from federal taxable income the gross receipts that are subject to the public service company franchise tax. The bill eliminates this subtraction modification. This will result in the imposition of the 7% corporate income tax on all income of electric and natural gas utilities. For electric utilities, this will result in an estimated liability before credits of $39.0 million for tax year 2000. For natural gas utilities, the estimate is $5.0 million.

The bill allows a credit against State corporate income taxes for electric utilities for 60% of property taxes paid on operating real property that is used to generate electricity for sale. In addition, certain multi-jurisdictional electric utilities are allowed a credit against State corporate income taxes equal to 25% of wages paid to employees at qualified corporate headquarters, not to exceed specified maximum credit amounts. Any credits in excess of the State corporate income tax liability may not be carried over to other tax years. For tax year 2000, the property tax credit for electric utilities is estimated to be $8 million; the payroll credit is estimated to be $2.5 million. The addition modification for these credits will increase State corporate income taxes by an estimated $0.7 million in tax year 2000.

Under the bill, income from the sale of electricity and natural gas will be subject to the State corporate income tax. Therefore, any gain or loss on the disposition of assets used in an electric or natural gas business will also be subject to tax. Because this income was not previously subject to the corporate income tax, electric and natural gas utilities in the State were not able to depreciate the assets currently in use for corporate income tax purposes. To conform with the federal tax treatment for a sale of those assets, the bill provides an adjustment to the gain or loss from the sale equal to the difference between the companies adjusted book value and the adjusted basis for federal tax purposes. The impact of this provision on revenues depends on the assets sold, the sale proceeds, the adjusted book value of the assets, and the adjusted federal tax basis of the assets, none of which can be estimated.

Under the bill, for a taxable year that begins in calendar 2000 the current law “safe harbor” of the prior year total liability for the estimated income tax payments does not apply. However, an alternative “safe harbor” is created for estimated income tax payments, such that if the public service company pays estimated franchise and income taxes that total to at least the prior year’s franchise tax paid, penalty and interest do not apply.

The combined impact of the provisions subjecting electric and natural gas utilities to the corporate income tax will result in an estimated increase in State revenues of $14.3 million in fiscal 2000, reflecting one-half of the tax year impact and the “safe harbor” provisions for estimated tax payments. In addition, there is one natural gas utility with a tax year that is different from the calendar year, so the revenues for the corporate income tax accrue to both general and special funds, with approximately 75% going to the general fund, and 25% to the Transportation Trust Fund (TTF). The changes to the corporate income tax, net of the credits allowed under the bill, result in an increase of $25.6 million in general funds in fiscal 2001, and an increase in special funds of $8.4 million. The following chart illustrates the changes to general and special fund revenues due to the corporate income tax.

**Changes in Corporate Income Tax**

| **($ in millions)** | **FY 2000** | **FY 2001** | **FY 2002** | **FY 2003** | **FY 2004** |
| --- | --- | --- | --- | --- | --- |
| General fund | $10.8 | $25.6 | $26.2 | $27.4 | $28.0 |
| Special fund (TTF) | $3.5 | $8.4 | $8.7 | $9.1 | $9.3 |

*State Property Tax*

This bill reclassifies cables, lines, poles, and towers of electric utilities companies as operating personal property rather than operating real property. Because personal property is not subject to the State property tax, State property tax revenues which would accrue to the Annuity Bond Fund will be reduced by an estimated $3.6 million annually beginning in fiscal 2001. This loss is estimated to increase by 2.6% per year.

*Sales and Use Tax*

The bill clarifies three provisions of current law related to the sales and use tax as it applies to electricity and natural gas. Specifically, the bill clarifies: that for electricity and natural gas, delivery is subject to tax, as a taxable service, if the sale of the electricity or natural gas is subject to the sales and use tax; the exemption from the sales and use tax for residential property; and the definition of production activity regarding generation of electricity.

Subject to specified exceptions, the bill imposes a special use tax on a kilowatt hour basis on electricity that is not delivered by a utility. The impact of this new tax on revenues cannot be reliably estimated at this time.

The table below shows the impact on State general and special funds of the changes to each of the four taxes.

**Impact on State Funds of Tax Provisions**

| ($ in millions) | FY 2000 | FY 2001 | FY 2002 | FY 2003 | FY 2004 |
|---|---|---|---|---|---|
| **General Fund** | | | | | |
| Public Service Company Franchise Tax | ($12.4) | ($17.6) | ($16.6) | ($15.7) | ($14.9) |
| Corporate Income Tax | $10.8 | $25.6 | $26.2 | $27.4 | $28.0 |
| Sales and Use Tax | Indeterminate | | | | |
| Total | ($1.6) | $8.0 | $9.6 | $11.7 | $13.1 |
| **Special Funds** | | | | | |
| Corporate Income Tax | $3.5 | $8.4 | $8.7 | $9.1 | $9.3 |
| Property Tax | $0.0 | (3.6) | (3.7) | (3.8) | (3.9) |
| Total | $3.5 | $4.8 | $5.0 | $5.3 | $5.4 |

**State Expenditures:** General fund expenditures will increase due to the special grants to the counties. The grants partially offset the cost to the counties of the 50% property tax exemption for personal property that is machinery or equipment used to generate electricity for sale. The grant is phased-in over a two-year period. The fiscal 2001 cost is $15.3 million, and when fully phased-in, the cost for fiscal 2002 and later years is $30.6 million each year.

In addition, a special grant is authorized for Calvert County if the Federal Nuclear Regulatory Commission license for the Calvert Cliffs Nuclear Power Plant expires and is not extended or renewed before January 1, 2020. The grant phases out over five years.

The Office of the Comptroller reports that their expenditures could increase by an estimated $50,500 in fiscal 2001 for the cost of one-time computer programming changes. The Department of Legislative Services advises that with the passage of other legislation requiring computer programming changes, economies of scale would be realized and reduce the estimated expenditures.

State property tax revenues are dedicated to paying debt service on State bonds. To the extent property tax revenues do not cover the cost of debt service, general fund expenditures make up the difference. The $3.6 million decrease in property tax revenues will result in a $3.6 million decrease in special fund expenditures for debt service and a corresponding increase in general fund expenditures. These amounts are expected to grow by 2.6% a year.

**Summary of State General Fund Expenditures**

| **($ in millions)** | **FY 2000** | **FY 2001** | **FY 2002** | **FY 2003** | **FY 2004** |
|---|---|---|---|---|---|
| Grants to Counties | $0.00 | $15.30 | $30.60 | $30.60 | $30.60 |
| Comptroller's Office | $0.00 | $0.05 | $0.00 | $0.00 | $0.00 |
| Debt Service | $0.00 | $3.60 | $3.70 | $3.80 | $3.90 |
| Total | $0.00 | $18.95 | $34.3 | $34.4 | $34.5 |

**Local Revenues:**

*Property Tax Revenues*

The bill phases-in over a two-year period beginning in fiscal 2001 a 50% exemption for personal property that is machinery or equipment used to generate electricity for sale. Under current law, this type of personal property is assessed at 100% and the local property tax rate is applied to the assessable base. This property tax exemption will result in a revenue loss to those counties where this type of property is located equal to: $20.1 million in fiscal 2001; $41.3 million in fiscal 2002; $42.4 million in fiscal 2003; $43.5 million in fiscal 2004; and $44.6 million in fiscal 2005.

*Transportation Trust Fund Revenues*

A portion of corporate income tax revenues are distributed to the Transportation Trust Fund. Part of these funds are shared with local governments. As a result, local government revenues will increase by $2.2 million in fiscal 2001, $2.3 million in fiscal 2002, $2.3 million in fiscal 2003, and $2.4 million in fiscal 2004.

*State Education Aid*

Approximately 55% of State Education Aid is allocated inversely to local wealth so less affluent jurisdictions receive more aid. Wealth is usually defined as some combination of property assessable base and net taxable income. Two of the State's primary aid programs, current expense and compensatory aid, include personal property assessable base as a wealth component to distribute aid to local governments. State funding for these programs is $1.7 billion in fiscal 2000. For purposes of calculating State aid under current law, the value of tax exempt property is excluded from a county's assessable base, while the value of property for which a tax credit applies is included in the base. As a result, the 50% exemption for personal property that is machinery or equipment used to generate electricity for sale will cause certain counties' assessable base to decrease, resulting in an increase in State aid to those counties. However, since only 50% of the personal property assessable base is included in a county's wealth base for aid purposes, the impact of the exemption on State aid is reduced.

*State Grants*

Local revenues will increase due to the State grant to offset the cost of the 50% property tax exemption for personal property that is machinery or equipment used to generate electricity for sale. The grant is phased-in over a two-year period to correspond to the phase-in of the exemption with the full grant amount beginning in fiscal 2002. The fiscal 2001 cost is $15.3 million. When fully phased-in, the fiscal 2002 cost is $30.6 million.

The table below shows the impact on county revenues of the property tax exemption, corporate income tax change, and the State grants.

**Summary of County Revenues**

| **($ in millions)** | **FY 2000** | **FY 2001** | **FY 2002** | **FY 2003** | **FY 2004** |
|---|---|---|---|---|---|
| Property Tax | | ($20.1) | ($41.3) | ($42.4) | ($43.5) |
| Highway User Fees | $0.9 | $2.2 | $2.3 | $2.3 | $2.4 |
| Grants | $0.0 | $15.3 | $30.6 | $30.6 | $30.6 |
| Total | $0.9 | ($2.6) | ($8.4) | ($8.5) | ($10.5) |

To show the combined impact of these provisions on local governments, the following table has been developed for fiscal 2003 only. The table shows the impact of the full 50% property tax exemption; the impact on State aid; the amount of the special grant; the change in the distribution from the TTF for highway user fees; and the combined impact of these changes on the local governments.

**Illustrative Impact on Local Government for Fiscal 2003**

| County | Property Tax Revenue Loss | Effect on Aid | State Grants | Change in Highway User Fees | Total Impact |
|---|---|---|---|---|---|
| | | | | | |
| Allegany | | ($59,006) | | $59,583 | $577 |
| Anne Arundel | ($10,799,377) | 1,151,452 | $7,820,202 | 230,633 | (1,597,090) |
| Baltimore City | (627,549) | (479,579) | 453,421 | 313,950 | (339,757) |
| Baltimore | (2,499,648) | (563,992) | 1,794,835 | 330,853 | (937,952) |
| | | | | | |
| Calvert | (8,489,883) | 1,402,036 | 6,096,574 | 43,732 | (947,541) |
| Caroline | | (25,304) | | 38,389 | 13,085 |
| Carroll | | (173,450) | | 102,716 | (70,734) |
| Cecil | | (89,149) | | 57,703 | (31,446) |
| | | | | | |
| Charles | (3,512,976) | 435,801 | 2,522,612 | 69,097 | (485,466) |
| Dorchester | (258,603) | 21,597 | 187,442 | 43,935 | (5,628) |
| Frederick | | (232,409) | | 132,679 | (99,730) |
| Garrett | (16,583) | (29,934) | 11,907 | 49,715 | 15,105 |
| | | | | | |
| Harford | (1,198,801) | (68,004) | 860,767 | 118,836 | (287,202) |
| Howard | | (375,081) | | 116,691 | (258,390) |
| Kent | | (24,548) | | 22,080 | (2,467) |
| Montgomery | (3,823,330) | (965,177) | 2,765,553 | 338,622 | (1,684,332) |
| | | | | | |
| Prince George's | (10,745,238) | 530,376 | 7,744,806 | 293,773 | (2,176,283) |
| Queen Anne's | | (54,276) | | 41,979 | (12,296) |
| St. Mary's | | (90,569) | | 53,913 | (36,656) |
| Somerset | | (15,750) | | 26,444 | 10,694 |
| | | | | | |
| Talbot | | (58,682) | | 34,344 | (24,339) |
| Washington | (389,219) | (55,964) | 357,082 | 89,754 | 1,653 |
| Wicomico | | (79,433) | | 69,346 | (10,087) |
| Worcester | | (93,323) | | 51,232 | (42,091) |
| | | | | | |
| **Total** | **($42,361,207)** | **$7,632** | **$30,615,201** | **$2,730,000** | **($9,008,373)** |

**Information Source(s):** Department of Assessments and Taxation, Comptroller of the Treasury (Bureau of Revenues Estimates), Department of Legislative Services, Baltimore Gas and Electric, Washington Gas and Light, Potomac Edison, Potomac Electric, Choptank, and Smeco

| | |
|---|---|
| **Fiscal Note History:** | First Reader - March 2, 1999 |
| ncs/jr | Revised - House Third Reader - April 6, 1999 |

Analysis by: Joanna Rooney

Direct Inquiries to:
John Rixey, Coordinating Analyst
(410) 946-5510
(301) 970-5510