

Outstanding Legal Issues for EAAC

Compiled by the Legal Issues Sub-Committee
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1. Is the State of CA allowed to run a deficit? Can bonds be issued to finance “off-budget” expenditures? How are bonds reconcilable?

The Governor must submit and the Legislature must approve a balanced budget, i.e., expenditures equal to revenues.¹ However, imbalanced budgets have occurred as both the Governor and Legislature have used unrealistic assumptions about revenues and expenditures. E.g., in the current budget, revenues to the state include \$1 billion based on the sale of the State Compensation Insurance Fund. Both the sale itself and the amount of revenues are uncertain.

Article 16 of the California Constitution specifies that the Legislature cannot create any debt or liability exceeding \$300,000, unless the debt is authorized by a specific law that provides a means, exclusive of loans, for the repayment of the debt or liability as it becomes due. (Under no circumstances may debt be issued to cover year-end budget shortfalls.) This general restriction applies to both general obligation and revenue bonds, as well as to other forms of long-term borrowing. (More on bonds directly below.)

A law authorizing a debt or liability takes effect only once it has been passed by a two-thirds vote of each house of the Legislature, has been submitted to the people and has received a majority of all votes cast. Once the law has been passed, the Legislature may reduce the amount of the indebtedness authorized by the law to an amount not less than that of the contracted debt; if no debt is contracted after approval, the Legislature may repeal the law.

Bonds can be issued to finance “off-budget” or special fund expenditures. Special fund bonds typically use a dedicated revenue stream and do not carry any General Fund (GF) debt service obligation. In short, special funds use a dedicated revenue stream, are generally *not* voter approved, and do not require the GF to be “on the hook.” [There remains a lack of consensus on this item.]

The state's General Fund is “on the hook” for debt service payments from all issued bonds, particularly if the bonds are voter approved. In cases where there is a separate revenue source (e.g., Proposition 57, which reduced payments to General Fund debt service from one-half to one-quarter cent of the state sales tax), the GF remains on the hook for any shortfall.

¹Proposition 58, the “California Balanced Budget Act,” passed by voters on March 2, 2004. Prior to Proposition 58, the Governor was required to submit a balanced budget by January 10, but there was no requirement for the Legislature to pass or the Governor to sign a balanced budget.

2. Can the state generally devote revenue from an AB 32-related program to the CA General Fund?

The state may devote revenue to the General Fund, but it is then subject to legislative appropriation and any other constitutional requirements (e.g., Proposition 98, which establishes minimum funding for K-14 education). Section 38597 of AB 32 explicitly provides this legislative appropriation role to the Legislature:

The state board may adopt by regulation, after a public workshop, a schedule of fees to be paid by the sources of greenhouse gas emissions regulated pursuant to this division, consistent with Section 57001.² The revenues collected pursuant to this section, shall be deposited into the Air Pollution Control Fund and are available upon appropriation, by the Legislature, for purposes of carrying out this division.

Legal Counsel from various agencies³ and from many private firms generally agree that fees may be collected via AB 32 as long as any associated programs are related to greenhouse gas reduction efforts. They also agree generally that these are fees and not taxes (which occur only with a two-thirds vote of the Legislature per Cal. Const., art. XIII (Prop. 13)). The consensus is that the state may collect fees according to AB 32 as long as the regulatory fees are imposed in an amount reasonably related to benefits received or burdens created by the feepayers.

3. Can the state devote revenue from an AB 32-related auction to the CA General Fund?

Some anti-tax groups and legal experts have argued specifically that the state may not collect GF or any revenue *through an auction*. According to the Howard Jarvis Taxpayers' Association:

[The} Air Resources Board has no legal authority to auction allowances based on silence of such discussion in AB 32. Other (U.S. Clean Air Act explicitly provides for sulfur dioxide permit auctions.) Under the California Administrative Act, "to be valid, administrative action must be within the scope of the authority conferred by the enabling statute." Ass'n for Retarded Citizens of Cal. v. Dep't of Developmental Serv., (1985) 38 Cal.3d 384, 391 (citing Govt. Code §§ 11342.1, 11342.2).⁴

This argument suggests that the Legislature could conduct an auction and dedicate those revenues to the General Fund only if the Legislature explicitly authorized ARB (or another state agency) to auction GHG allowances. This

² Provides general guidelines for California Health and Safety fee assessments.

³ See, for example, letter from Deputy AG Molly Moseley to ARB, Aug. 12, 2009.

⁴ Letter from Howard Coupal to Joe Nation, Nov. 12, 2009.

argument also suggests (perhaps excessively) that such authorization for an auction would also require the Legislature to establish carbon market design principles, such as allocation policy, the point of regulation, price controls, and other elements.

4. Does Sinclair pose a barrier to AB 32-related revenues 1) for dividends 2) for tax-shifting 3) for other purposes?

Sinclair appears to pose significant barriers. In particular, it requires a nexus between revenues collected and any programs. However, as noted above, a broad range of greenhouse gas reduction programs likely satisfy that test.

Because AB 32 was a majority vote bill, revenues may be classified as fees rather than general taxes.⁵ As such, those fees must also be reasonably related to benefits received or burdens created by the feepayers. The use of the fees must be for the purposes outlined in AB 32 (worker retraining, technology development, and so forth). A pending case (*California Farm Bureau v. California State Water Resources Control Board* (2007) 53 Cal. Rptr.3d 445, reh'g. den. Feb. 16, 2007, review granted April 11, 2007 S150518) may clarify the Sinclair ruling.

One possible alternative to this Sinclair restriction and the public fund issues to freely allocate allowances to local electric and gas distribution companies (LDCs), for the benefit of end-use customers who will ultimately bear the cost of GHG controls. The LDCs would then offer the allowances up for auction by an independent entity with auction revenues returned to LDC customers. Such an approach might avoid this Sinclair issue since the auction revenues would never be subject to GF restrictions.

Fees from AB 32 may also be limited to necessary administrative costs per the “reasonableness” argument noted above. For example, AB 32 author Nunez submitted a clarifying letter on AB 32 indicating that it was his “intent that any funds provided by Health & Safety Code Section 38597 are to be used solely for the direct costs incurred in administering this division.”⁶ However, reviewing courts traditionally give letters from individual legislators little weight in ascertaining legislative intent.

Finally, some argue that any fees imposed from AB 32 implementation must be equitably allocated among fee payers, as required in Section 38562 of AB 32. Although unlikely, that could lead to arguments that high fees for large greenhouse gas emitters might not be equitable and not permitted, even if AB 32 fees were approved.

⁵ An opposing (and perhaps correct) view holds that reviewing courts have and will apply a functional analysis—not a legislative vote threshold—in determining whether a particular financial assessment is a tax or a fee under Sinclair principles.

⁶ Nunez letter to E. Dotson Wilson, Chief Clerk of the Assembly, Aug. 31, 2006

5. Does the language of AB 32 require that some kind of provisions for local environmentally impacted communities be included in the allocation package?

There is an obligation under AB 32 *not* to make things worse regarding co-pollutants. However, that does not *prevent* steps to reduce co-pollutant levels (Section 38570 of AB 32):

Prior to the inclusion of any market-based compliance mechanism in the regulations, to the extent feasible and in furtherance of achieving the statewide greenhouse gas emissions limit, the state board shall do all of the following:; (1) Consider the potential for direct, indirect, and cumulative emission impacts from these mechanisms, including localized impacts in communities that are already adversely impacted by air pollution.; (2) Design any market-based compliance mechanism to prevent any increase in the emissions of toxic air contaminants or criteria air pollutants.; (3) Maximize additional environmental and economic benefits for California, as appropriate.

6. What are the legal or institutional impediments to linkages with other states' systems, with a federal system, or with the EU?

a) Linkages with other States

There are two principal, potential impediments to California linking its cap-and-trade program(s) with other states, one obvious, the other less so. First, any such linkage must be compatible with the legal authority granted by each agreeing state. I.e., state X is not obliged to adopt a California-enacted cap-and-trade program in its own jurisdiction and, indeed, could be prohibited from doing so under state X's own constitution or statutes.

The other impediment is contained in the Compact Clause of the U.S. Constitution, Art. I, § 10, cl. 3. That constitutional provision provides that "Agreements" and "Compacts" between two or more states are not effective unless they have been reviewed and ratified by Congress. Note, however, that states often have working arrangements or informal agreements with their sister states, and that these have rarely been challenged as violative of the Compact Clause. Most relevant to this discussion is the fact that California has previously entered into the Western Climate Initiative with a number of Western States, in order to advance collective climate change goals; that initiative has not been challenged in court as a violation of the Compact Clause.)

We should also examine the RGGI system which did not use an interstate compact and relied upon any independent entity to conduct the allowance auction.

b) Linkages with a Federal System

Proposed linkages between California's cap-and-trade program(s) and the federal government's pose the least legal difficulty. Under the Supremacy Clause of the U.S. Constitution (Art. VI, cl.2), federal law is the supreme law of the land and preempts countervailing state or local laws. Under established preemption principles, a state cap-and-trade law would be preempted by federal law if Congress expressly declares that federal law on the subject is exclusive; if the state program actually conflicts with the federal system; or if Congress indicates an intention to preempt state cap-and-trade programs.

Accordingly, a California cap-and-trade program can link to a federal cap-and-trade program if Congress, in enacted federal climate change legislation, expressly allows it or, at least, does not prohibit such linkage or enact federal legislation making such linkage impossible.

c) Linkages with EU System(s)

This is the most challenging legal area for a proposed California cap-and-trade program. Under a federal constitutional principle known as the "foreign powers doctrine," the federal government has exclusive authority to negotiate treaties, trade agreements and similar, formal compacts with foreign nations. Individual states, by contrast, lack the authority to conduct foreign policy with other nations, or to intrude upon the federal government's ability to do so. The more difficult question is whether and to what extent California could formally link its cap-and-trade program to that of the EU in the face of no action/utter silence by the federal government on the subject. This is a close question, although it can be expected that interested third parties would challenge such a California-EU linkage as violative of the foreign powers doctrine. However, while short of formal linkage, California could decide to accept allowances or certified reductions from other systems.

7. Are there different tax implications to individuals or businesses that receive allowance value via free allowances vs. cash from auction proceeds?

There are many unsettled questions of law with regards to the taxation of free allowances. Under current practice, it is likely that free allowances would be treated differently, and probably more advantageously, under federal tax code, than cash from auction proceeds. This could change, however, if the IRS provides additional guidance on the issue. Certainly, the California Legislature could provide that free allowances are not considered taxable income; however, those free allowances could be considered taxable income at the federal level.

As the Congressional Joint Committee on Taxation staff pointed out in a report, free allowances are difficult to classify for tax purposes because on the one hand, they are expected to be "valuable financial instruments," and on the other

hand, they operate in some ways like non-taxed government licenses.⁷ For example, proposed federal comprehensive climate change legislation creates a market for the trading of allowances but also explicitly states that an allowance does not constitute a property right.⁸

Under current IRS guidance, free allowances granted to a utility under the Clean Air Act's acid rain program do not constitute income upon receipt and have no tax basis.⁹ Allowances that are sold, as opposed to surrendered to the government, generally produce a capital gain or loss.¹⁰ In contrast, revenue from auction proceeds would generally constitute taxable income upon receipt. One exception, described in #4 above, would involve the free allocation of allowances to emitters, the subsequent auction of those allowances with proceeds only to end-users. In this case, revenues could be designed so as to prevent the grants from giving rise to taxable income.

Because the IRS guidance addressing the acid rain program does not include a rationale for the decision, addresses only regulated entities, and applies to a much more limited emissions trading program, it is quite possible that IRS would issue different guidance for a different program.

The U.S. Senate Committee on Finance held a hearing on tax considerations of climate change legislation on June 16, 2009. Issues raised by the staff report and witnesses included: a difference of opinion about whether to treat allowances as income, and if treated as income, whether they should be treated as income upon receipt or upon use; whether the method of taxation should depend on the type of entity holding the allowance (e.g. regulated entity, non-regulated emitter, or trading institution); whether allowances should be treated as business deductions; and whether different types of permits should be considered a like-to-like exchange.

Finally, the purchase of allowances for businesses should be deductible. If the purchase covers a period of more than one year, those cost should be amortizable. Free allowances are unlikely to be deductible.

⁷ STAFF REPORT, JOINT COMMITTEE ON TAXATION, CLIMATE CHANGE LEGISLATION: TAX CONSIDERATIONS (2009), <http://www.jct.gov/publications.html?func=startdown&id=3559>.

⁸ American Clean Energy and Security Act, H.R. 2454, 111th Cong. § 721(c) (2009); Clean Energy Jobs and American Power Act, S. 1733, 111th Cong. § 721(c)(1) (2009).

⁹ Revenue Ruling 92-16, 1992-1 C.B. 15 ("The allocation of emission allowances by the Environmental Protection Agency and their receipt by a utility pursuant to 42 U.S.C. section 7651b (a) does not cause the utility to realize gross income under section 61 of the Internal Revenue Code.")

¹⁰ See 26 U.S.C. §§ 1001(a), 1221(a); Revenue Procedure 92-91 (under certain exceptions, however, the gain or loss will be ordinary).