Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Ridley-Thomas	Analyst:	Gail Hall	Bill Number:	AB 912
Related Bills:	See Legislative History	Telephone:	845-6111	Introduced Date:	February 18, 2005
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Exclusion/Interest Earned By Financial Corporations On Loans Granted For Redeveloping Brownfields Located in Blighted Areas.

SUMMARY

This bill would allow interest income to be exempt from tax for certain corporations as specified.

PURPOSE OF THE BILL

The author's staff has indicated that the purpose of the bill is to provide an incentive to financial corporations to loan money for the purpose of improving economically depressed areas.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately and would apply to taxable years beginning on or after January 1, 2006.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Federal law defines a "financial corporation" as a corporation that derives at least 80% of its gross income from financial services, such as banking, financing, or similar business. Interest earned by a financial corporation is included in gross income and subject to federal tax.

Current state law defines a "financial corporation" as a corporation that derives over 50% of its total gross income from transactions attributable to money or moneyed capital.[1] "Money or moneyed capital" includes, but is not limited to, coin, cash, currency, mortgages, deeds of trust, conditional sales contracts, loans, commercial paper, installment notes, credit cards, and accounts receivable.[2] Interest earned by a financial corporation on these transactions is included in gross income and subject to tax. A domestic financial corporation is a financial corporation formed under the laws of the state of California, or in other words, incorporated in California.

[1] Cal. Code Regs. 23183(a).
[2] Cal. Code Regs. 23183(b)(3)

Board Position:			Department Director	Date
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For financial corporations, the normal apportionment rules apply and gross interest income is included in the sales factor. For sales factor purposes, interest income from loans secured by real estate is assigned to the state where the property is located,[3] and interest income from unsecured loans is assigned to the state where the borrower is located[4].

A brownfield is defined in the Health and Safety Code as property that meets all of the following conditions:

1. located in an urban area,
2. was previously the site of an economic activity that is no longer in operation at that location, and
3. has been vacant or has had no occupant engaged in an economically productive activity for a period of not less than the 12 months previous to the date of application for a loan.

A brownfield does not include any of the following:

1. property listed, or proposed for listing, on the National Priorities List, a list that prioritizes hazardous sites for investigation by the Environmental Protection Agency,
2. property that is, or was, owned or operated by a department, agency, or instrumentality of the United States, or
3. property that will be the site of a contiguous expansion or improvement of an operating industrial or commercial facility, unless the property is a brownfield.

The term "blighted area" is defined in the California Health and Safety Code and generally includes areas that have physical and economic disadvantages requiring redevelopment in the interest of health, safety, and general welfare of the people of these communities and of the state.

A blighted area is one that contains both of the following:

1. An area that is predominantly urbanized and is an area in which the combination of physical conditions caused by blight is so prevalent and so substantial that it causes a reduction of, or lack of, proper utilization of the area to such an extent that it constitutes a serious physical and economic burden on the community which cannot reasonably be expected to be reversed or alleviated by private enterprise or governmental action, or both, without redevelopment.
2. An area that is characterized as having one or more physical or economic conditions of blight. A blighted area may also be characterized by the existence of inadequate public improvements, parking facilities, or utilities.

Examples of blight are:

1. unsafe or unhealthy buildings for persons to live or work,
2. faulty lot layout in relations to size, adequacy, accessibility, or usefulness,
3. unsafe or unsanitary conditions,
4. high vacancy rates for residential or commercial property as compared to other areas,
5. incidence of crime in the area is high as compared to other areas, and
6. deterioration of site or other improvements.

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[3] Cal. Code Regs. Section 25137-4.2(c)(3)(C)
[4] Cal. Code Regs. Section 25137-4.2(c)(3)(D)

THIS BILL

This bill would allow financial corporations, incorporated in California, to exclude any amount of interest income received on loans granted for purposes of redeveloping brownfields that are located in blighted areas.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

1. For the bill's interest exclusion, it is unclear how the department would examine a tax return and determine the amount of the exclusion unless a line item or separate tax form is required to disclose the amount of exclusion. If a separate form is required, this would impact the department for the design of the form and the update to the applicable tax instructions, computer systems, and the department's website.

2. It is unclear if the excluded interest income would also be excluded from the sales factor for calculating the apportionment formula for multistate financial corporations.

3. This bill differs from the net interest deduction for enterprise zones, in that it calls for the exclusion of interest income versus a net interest deduction. It is unclear how the interest exclusion will be reported or disclosed on the state tax return. The author might consider expanding the enterprise zone net interest deduction to include brownfield development.

LEGISLATIVE HISTORY

There have been prior bills that provided tax relief for economically depressed areas, but no specific bill excluded interest income, received by domestic financial corporations, on loans provided to improve economically depressed areas.

OTHER STATES' INFORMATION

The states surveyed included Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York. These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Although these states do have some tax incentives relating to physical and economically depressed areas, they lack specific laws similar to this bill.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue losses.

Estimated Revenue Impact of AB 912 As Introduced 2/18/05 [$ In Millions]			
Assumed Level of Excluded Interest	2005-06	2006-07	2007-08
$10 Million	- a/	- $1.0	- $1.0
$25 Million	- $1.0	- $2.5	- $2.5
$100 Million	- $4.0	- $10.0	- $10.0
a/ Loss of less than $500,000.			

Revenue Discussion

The revenue impact of the bill would be determined by the amount of interest excluded from income by domestic financial corporations and the tax rate of corporations making such loans for redeveloping brownfields located in blighted areas.

California has an estimated 100,000 brownfield sites, the majority of which are located in urban areas and downtown communities. Most brownfields are located in blighted areas. Redevelopment primarily financed by loans, grants, and issuance of tax allocation bonds.

The level of qualifying existing and/or new loans by roughly 400 taxable domestic financial corporations in any future year is unknown. For purposes of an estimate, three possible interest exclusion amounts are assumed: $10 million, $25 million, and $100 million. These interest amounts are multiplied by an average apportionment factor (if applicable), and a financial tax rate of 10.84% to derive the potential tax revenue loss. Revenue effects in the initial year are assumed at 40% of a full-year effect.

TECHNICAL CONSIDERATIONS

The author should consider defining “redevelopment” as this term could encompass a broad spectrum of activities. A comprehensive definition may be found in sections 33020 and 33021 of the Health and Safety Code.

LEGAL IMPACT

This bill allows an interest exclusion for domestic financial corporations incorporated in California but not for financial corporations incorporated outside of California. This limitation may be subject to constitutional challenge as a preferential treatment for companies incorporated in California is in violation of the commerce clause.

ARGUMENTS/POLICY CONCERNS

The department has identified the following policy concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

1. This bill calls for the exclusion of gross interest income rather than net interest income. Therefore, all interest expense related to the excluded interest income would still be deducted. In a financial corporation, interest expense can represent a significant percentage of the cost of doing business. Under this scenario, there is no matching of income and related expenses.

2. It could be argued that this bill would apply to loans granted before its effective date. The bill specifies that interest income received after the effective date of this bill would qualify for exclusion, but does not specify that only loans approved after the effective date qualify under this bill.

LEGISLATIVE STAFF CONTACT

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