Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Swanson	Analyst:	Nicole Kwon	Bill Number:	AB 579
Related Bills:	See Legislative History	Telephone:	845-7800	Introduced Date:	February 21, 2007
		Attorney:	Daniel Biedler	Sponsor:	

SUBJECT: Interest Deduction/Payments On Indebtedness To Taxpayers Engaged In Trade Or Business In Local Agency Military Base Recovery Area (LAMBRA)

SUMMARY

This bill would allow a deduction for interest received by lenders on loans made to a trade or business located within a Local Agency Military Base Recovery Area (LAMBRA).

This bill would also amend some provisions of the Government Code relating to LAMBRAs; however, those provisions do not apply to the Franchise Tax Board (FTB) and this analysis addresses only those provisions of the bill affecting FTB.

PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to expand the tax incentives allowed in LAMBRAs to further enhance and stimulate the growth of the economically impacted areas due to closure of military bases.

EFFECTIVE/OPERATIVE DATE

If enacted in 2007, this bill would be effective and operative for taxable years beginning on or after January 1, 2008.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Under the Government Code, existing state law provides for the designation of LAMBRAs. Using specified criteria, the Department of Housing and Community Development (DHCD) designates a LAMBRA based on applications received from the governing bodies. LAMBRA designations are authorized for eight years. Currently, there are eight LAMBRAs.

Board Position:			Department Director	Date
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Under the Revenue & Taxation Code, existing state law provides special tax incentives for taxpayers conducting business activities within the LAMBRA. These incentives include a sales or use tax credit, a hiring credit, and a business expense deduction.

Current state law allows a deduction from income for the amount of net interest earned on loans made to a trade or business located in an Enterprise Zone (EZ). For purposes of determining the net interest deduction, net interest is gross interest received less related interest expense (cost of funds) and any other directly related expenses. The loan must be used solely for business activities within the EZ, and the lender may not have an equity or other ownership interest in the EZ trade or business. This incentive is not available for LAMBRAs, a Targeted Tax Area, and Manufacturing Enhancement Areas.

THIS BILL

This bill would allow a deduction for interest received by lenders on loans made to a person or entity engaged in a trade or business located in a LAMBRA.

This bill would require a taxpayer-lender to notify the applicable LAMBRA within 90 days of the loan closing with the following information: (1) the total amount of indebtedness authorized, and (2) whether the indebtedness is appropriate to be reported under the taxpayer's requirements set forth in the federal Community Reinvestment Act.

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.

The author's office may want to revise the language on both personal and corporate income tax law sections to state clearly how the loan proceeds should be spent within the LAMBRA to qualify for the deduction. For example, to qualify for the EZ interest deduction, the loan proceeds are spent for expenditures for assets solely used in or services received in an EZ.

The department's administration of the provision of this bill would be benefited by requiring the taxpayers to retain the notification required under this bill and present the notification upon the request from the department.

TECHNICAL CONSIDERATION

The term "debtor" on page 4, line 17 is not defined in the bill. The author's office may want to add "(debtor)" on page 4, line 9, before "is".

LEGISLATIVE HISTORY

AB 1766 (Dymally, 2005/2006) and SB 1008 (Ducheny and Machado, 2005/2006) would have limited the deduction to interest received on loans made to businesses that are physically located within the EZ. AB 1766 died on the Senate floor; SB 1008 was held at the Assembly Jobs, Economic Development & Economy Committee.

OTHER STATES' INFORMATION

Florida, Massachusetts, Michigan, Minnesota, and *New York* laws do not provide a deduction comparable to the deduction allowed by this bill. The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

Illinois has a Growing Economy Tax Credit Act that provides tax credits to businesses creating new jobs and making capital investments. A taxpayer that has entered into an agreement under the Growing Economy Tax Credit Act is allowed a credit against the tax. The Department of Revenue and the Illinois Business Investment Committee determine the amount and duration of the credit, which must not exceed 10 taxable years. Under *Illinois* law, a subtraction is allowed to financial organizations for interest from a loan or loans to a borrower, to the extent the loan is secured by property that is eligible for the EZ investment credit.

FISCAL IMPACT

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

ECONOMIC IMPACT

<u>Revenue Estimate</u>

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

Estimated Revenue Impact of AB 579 Effective for Tax Years BOA 1/1/2008 Assumed Enactment Date after 6/30/2007 ($ in Millions)		
2007/08	2008/09	2009/10
Less than - $0.25	-$0.5	-$0.7

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

<u>Revenue Discussion</u>

The proposed net interest deduction would allow a deduction from income for the amount of net interest income received in payment on loans used exclusively for trade or business within a LAMBRA. A similar net interest deduction is available under current law for interest received from loans made to a trade or business located solely within an EZ. This estimate was based on a percentage of the anticipated EZ net interest deduction. The loss in tax revenue is the tax effect of the proposed net interest deduction.

Utilization of the various tax incentives related to EZs and LAMBRAs was compared over several years. Utilization of the hiring and sales or use tax credits for LAMBRAs ranged from 0.25% to 4.5% of EZ utilization. Utilization of the business expense deduction for LAMBRAs ranged from 1.25% to 4% of EZ utilization. For purposes of this proposal, it was assumed that LAMBRA net interest deduction utilization would be approximately 2% of EZ net interest deduction utilization. The anticipated EZ net interest deduction utilization for 2008 tax year is $500 million. Thus, estimated LAMBRA net interest deduction is $10 million ($500 million x 2%). Applying an average tax rate of 7%, estimated revenue loss is $700,000 ($10 million x 7%). Estimates presented in the table above have been adjusted to reflect fiscal year impacts.

LEGAL IMPACT

This bill would require taxpayers a deduction for interest received by lenders on loans made to a trade or business located within a LAMBRA in the state. This requirement may be subject to constitutional challenge under the Commerce Clause of the United States Constitution.

POLICY CONSIDERATION

Federal law prohibits discriminatory state taxation of interest on federal obligations. This bill provides a deduction to creditors for interest earned on loans made to a trade or business located in a LAMBRA. This subsidy could be interpreted to subject interest on federal obligations to a discriminatory state franchise tax in violation of federal law.

LEGISLATIVE STAFF CONTACT

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