Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Lowenthal	Analyst:	Angela Raygoza	Bill Number:	SB 585
Related Bills:	See Legislative History	Telephone:	845-7814	Amended Date:	May 1, 2008
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Low-Income Housing Tax Credit Allocation

SUMMARY

This bill would specify how the Low-Income Housing Credit (LIHC) may be allocated to partners and when losses of partners are recognized upon disposition.

SUMMARY OF AMENDMENTS

The May 1, 2008, amendments would do the following:

- Allow LIHC to be allocated to partners of a partnership in accordance with the partnership agreement, regardless of the federal LIHC allocation among the partners and regardless of whether the allocation to the partners has substantial economic effect.
- Defer losses or deductions attributable to the sale or disposition of a partnership interest.
- Provide that the partnership allocation rules outlined above apply to LIHC allocated on or after January 1, 2009, and before January 1, 2016.

This is the department's first analysis of this bill.

PURPOSE OF THE BILL

According to the author's office, this bill would increase the pool of affordable housing investors and the demand for state credits.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would take effect immediately and be specifically operative for credits allocated on or after January 1, 2009, and before January 1, 2016.

POSITION

Pending.

Board Position:			Department Director	Date
_______ S	_______ NA	_______ NP		
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_______ N	_______ OUA	___X___ PENDING		

ANALYSIS

FEDERAL/STATE LAW

Current federal tax law allows a tax LIHC for the costs of constructing, rehabilitating, or acquiring low-income housing. The credit amount varies depending on several factors, including when the housing was placed in service and whether it was federally subsidized. The credit is claimed over ten years. The California Tax Credit Allocation Committee (TCAC) has the authority to oversee the process and allocate the federal credit.

Current state tax law generally conforms to federal law with respect to the LIHC, except that the state LIHC is claimed over four taxable years, is limited to projects located in California, and is allocated in amounts equal to the sum of all the following:

- For calendar years ending 2002 and thereafter, $70 million increased by the percentage by which the Consumer Price Index (CPI), for the preceding calendar year, exceeds the CPI for the 2001 calendar year.
- The unused housing credit ceiling, if any, for the preceding calendar years, and
- The amount of housing credit ceiling returned in the calendar year.

Current federal and state income tax law requires a partner's distributive share of income, gain, loss, deduction, or credit to be determined in accordance with the partner's interest in the partnership by taking into account all facts and circumstances if one of the following occurs:

- o The partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit, or
- o The allocation to a partner under the agreement of income, gain, loss, deduction, or credit does not have substantial economic effect.

THIS BILL

This bill would allow LIHC to be allocated to the partners of a partnership owning a low-income housing project in accordance with a partnership agreement, regardless of how the federal LIHC is allocated to the partners or whether the allocation of the credit under the terms of the agreement has substantial economic effect.[1] This provision would apply to state LIHC allocated on or after January 1, 2009, and before January 1, 2016.

This bill would require a deferral of any loss or deduction attributable to the sale, transfer, exchange, abandonment, or any other disposition of a partnership interest where the credit was allocated without substantial economic effect. The loss would be deferred until the first taxable year immediately following the end of the ten year credit period which the federal credit is allowed.

[1] Internal Revenue Code section 704 (b) defines partner's distributive share with respect to substantial economic effect.

The bill would make the provision to defer losses or deductions attributable to the sale or disposition of a partnership interest inoperative on or after January 1, 2016.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would not significantly impact the department's programs and operations.

TECHNICAL CONSIDERATIONS

Amendments 1-7 have been provided to correct technical errors.

LEGISLATIVE HISTORY

SB 713 (Lowenthal, 2007/2008) and AB 1903 (1999/2000) are similar to this bill as they would have allowed the state LIHC to be distributed among partners pursuant to a partnership agreement, even if the allocation of that credit did not have substantial economic effect. In addition, these bills would have consolidated the farmworker housing tax credit program into the state LIHC. SB 713 failed to pass out of the Assembly Appropriations Committee. AB 1903 was vetoed by Governor Davis on September 30, 2000, stating, "I am concerned about the possible abuses that may arise. Specifically, since this bill would allow a credit to be severed from the economic interest each partner has in the profits and losses of the project, it could lead to allocations for tax shelter purposes." Please see Attachment A for the complete veto message.

OTHER STATES' INFORMATION

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

FISCAL IMPACT

This bill would not impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

The Personal Income Tax and Corporation Tax revenue impact from this bill would be as follows:

Revenue Analysis for SB 585 – As Amended on May 1, 2008 Operative January 1, 2008 Enactment Assumed after June 30, 2008 ($ in Millions)			
Fiscal Year	2008-09	2009-10	2010-11
Low Income Housing Credit (LIHC)**	$0	$0	$0

** Beginning in fiscal year 2011-2012, the LIHC provisions of this bill would result in an estimated revenue loss of $0.7 million. Losses increase each year thereafter. When fully phased in (fiscal year 2014-2015), the potential annual revenue losses would be $1.2 million from accelerated usage. Starting with fiscal year 2022-2023, ten years following first tax year of the federal credit period, there will be an estimated revenue loss of $0.2 million from capital losses on abandonment.

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

Revenue Discussion

This bill allows for bifurcation of the federal-state LIHC on a prospective basis for credit reservations made after January 1, 2008. Because of the estimated three-to-four-year delay from the date of preliminary reservation to the date final allocation is given, the revenue impact from accelerated credit usage would not occur until the 2011 tax year. The corresponding fiscal effect would be outside the normal budget window. This analysis assumes that 4% of credits allocated are unapplied after the four-year tax credit period. In 2011, it is estimated that 25% of the currently unused credit would be applied under this bill resulting in approximately $700,000 of accelerated revenue losses.

This bill allows a low-income housing partnership to share the state LIHC in disproportion to the economic interest of the individual partners. If a partner or member who purchases the bifurcated state LIHC has no other tie to the partnership after allocated credits are applied, the act of abandoning their interest results is an added tax benefit. The benefit occurs as a deductible capital loss on abandonment equal to the purchase price of the partnership/Limited Liability Company share that was created for the sole purpose of distributing the LIHC. This analysis assumes no more than 10% of future credit allocations would result in a capital loss on abandonment in any given year beginning with tax year 2022 (3-year lag + 10-year federal credit allocation period + 1 year following expiration of federal credit = 2008 + 14 years).

For the first year, there is an impact from the abandonment loss (2022). It is assumed that this bill would result in capital losses equal to 2.5% of the credits generated that year. Thus, based on a projected $103 million in state LIHC generated in 2021, the amount of capital losses generated in the 2022-2023 fiscal year would be approximately $2.6 million ($103 million X 2.5%). Because most partners are corporations, the $2.6 million is multiplied by an 8.84% tax rate to arrive at a state revenue loss of approximately $0.2 million. It is assumed that in later years the amount of capital losses generated from abandonment would equal 10% of state LIHC credits generated, equal to approximately $1 million for the 2024-2025 fiscal year.

POLICY CONCERN

This bill would disconnect ownership of the property from eligibility for the credit, thus severing the credit from a taxpayer's economic interest in the profits and losses of the project. Because the Committee could issue this credit to any partnership, corporation, or business entity, this action could lead to allocations for tax shelter purposes. For example, investors would be able to "buy" rights to low income housing credits through the purchase of a partnership share. When all of the credits, which could exceed the cost of investment, have been utilized, the investor could walk away from the partnership with a partnership loss to apply against other partnership income.

As a result, the investor would benefit twice from the arrangement: first by use of the credit and second by the partnership loss.

LEGISLATIVE STAFF CONTACT

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ATTACHMENT A

BILL NUMBER: AB 1903
VETOED DATE: 09/30/2000

September 30, 2000

To Members of the California Assembly:

I am returning Assembly Bill 1903 without my signature.

This bill would allow the State low-income housing credit to be distributed among partners pursuant to a partnership agreement, even if the allocation of that credit to the partner under that agreement does not have substantial economic effect.

Although I am aware this bill could increase the value of the low-income housing credits by allowing the credit to be targeted to those entities that can use it, I am concerned about the possible abuses that may arise. Specifically, since this bill would allow a credit to be severed from the economic interest each partner has in the profits and losses of the project, it could lead to allocations for tax shelter purposes.

For example, under this bill, investors would be able to "buy" rights to low-income housing credits through the purchase of a partnership share. When they had utilized all of the credits (which could exceed the cost of their investment), they could walk away from the partnership investment and have a negative basis in the investment. This would allow them to write off the amount of the negative basis against other income. Thus, the investor would benefit twice from the arrangement-the use of the credit and the negative basis.

I am committed to expanding housing opportunities for all Californians. The 2000 Budget Act includes over $580 million General Fund in support for housing, with almost 50% of this amount dedicated toward low-and moderate-income housing. For the reasons I have stated above, I am returning AB 1903 unsigned.

Sincerely,

GRAY DAVIS

Analyst Angela Raygoza
Telephone # 845-7814
Attorney Patrick Kusiak

FRANCHISE TAX BOARD’S
PROPOSED AMENDMENTS TO SB 585
As Amended May 1, 2008

AMENDMENT 1

On page 13, line 31, strikeout “Any” and insert:

To the extent the allocation of the credit under this section to a partner lacks substantial economic effect, any

AMENDMENT 2

On page 13, line 32, after “disposition of” strike “a” and insert:

that partner’s

AMENDMENT 3

On page 13, line 33, strike “expiation,” and insert:

expiration

AMENDMENT 4

On page 13, line 35, after “deferred until” insert:

and treated as if it occurred in

AMENDMENT 5

On page 23, line 18, strikeout “Any” and insert:

To the extent the allocation of the credit under this section to a partner lacks substantial economic effect, any

AMENDMENT 6

On page 23, line 19, after “disposition of” strike “a” and insert:

that partner’s

AMENDMENT 7

On page 23, line 22, after “deferred until” insert:

and treated as if it occurred in