BILL ANALYSIS

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Department, Board, Or Commission	Author	Bill Number
Franchise Tax Board	**Lowenthal**	**SB 585**

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 of the partnership interest.

PURPOSE OF BILL

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

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would take effect immediately and be specifically operative for projects that receive a preliminary reservation of the state LIHC on or after January 1, 2009, and before January 1, 2016.

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:

- The partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit, or

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- The allocation to a partner under the agreement of income, gain, loss, deduction, or credit does not have substantial economic effect.

<u>THIS BILL</u>

This bill would require a project that receives a preliminary reservation of the LIHC on or after January 1, 2009, and before January 1, 2016, 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 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 during which the federal credit is allowed.

The bill would make the provision to permit allocation of credits to a partner without substantial economic effect and to defer losses or deductions attributable to the sale or disposition of a partnership interest inoperative on or after January 1, 2016.

This bill also contains double-jointing language that would incorporate provisions from SB 1247 that would consolidate the Farmworker Housing Credit (FWHC) into the state LIHC. The double-jointing language would allow a FWHC that does not have a corresponding federal LIHC to be allocated to partners lacking substantial economic effect, thereby creating abandonment losses without a ten-year "waiting period."

LEGISLATIVE HISTORY

SB 1247 (Lowenthal, 2007/2008) would consolidate the FWHC program into the state LIHC. This bill was referred to the Assembly floor.

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.

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[1] Internal Revenue Code section 704 (b) defines partner's distributive share and prohibits allocations that lack substantial economic effect.

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 revenue impact from this bill would be as follows:

Revenue Analysis for SB 585 – As amended on 7/14/08 Operative January 1, 2009			
Fiscal Year	2008-09	2009-10	2010-11
Low Income Housing*	$0	$0	$0

*Beginning in fiscal year 2012-13, 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 (2015-16 fiscal year), the potential annual revenue losses would be $1.2 million from accelerated credit usage. Starting with fiscal year 2023-24, ten years following the 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 a federal-state LIHC to be divided on a prospective basis for preliminary credit reservations first made after January 1, 2009. Due to 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 2012 tax year. This analysis assumes that 4% of credits allocated are unapplied after the four-year credit period. In 2012, it is estimated that 25% of $2.8 million in unapplied LIHC would have accelerated usage resulting in $700,000 ($2.8 million unapplied LIHC X 0.25 = $700,000 loss) of revenue losses. The revenue impact would occur outside the budget window.

This bill allows a low-income housing partnership to distribute the state LIHC to partners without economic interest in the housing project. If a partner or member who purchases the divided state LIHC has no other connection to the partnership after allocated credits are applied, the act of abandoning their interest results in an added tax benefit. The benefit occurs as a deductible capital loss on abandonment that is equal to the purchase price of the partnership/LLC share that was created for the sole purpose of distributing the LIHC. This analysis assumes that no more than 10% of future credit allocations would result in a capital loss on abandonment in any given year beginning with tax year 2023 (three-year lag plus 10-year federal credit allocation period plus one year after credit period expires = 2009 plus 14 years).

For the first year (2023) there is an impact from the abandonment loss, it is assumed that the bill would result in capital losses equal to 2.5% of the credits generated that year. Based on a projected $103 million in state LIHC generated in 2022, the amount of capital losses generated in the 2023-24 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 in total revenue losses ($108 million X .10 assumed abandonment losses X .0884 tax rate ≈ $1 million revenue losses) in the 2025-26 fiscal year.

The July 14, 2008, amendments clarify that the division of credits applies only to projects that receive a preliminary reservation of the LIHC on or after January 1, 2009. The revenue change from this amendment is insignificant.

Revenue Effects from Double-Jointing

The double-jointing amendments do not directly impact the revenue estimate for SB 585. However, if both this bill and SB 1247 pass, there will be an estimated revenue impact from abandonment losses attributed to farm worker housing credits (FWHC) of less than $150,000 beginning in 2021-22 from the FWHC provisions in SB 1247.

For partnerships that work on FWHC project and receive a federal credit, the value of any future revenue losses is equal to the marginal tax rate times the total amount of abandonment losses claimed. Assuming that the total FWHC is less than $50,000 and that 40% of these credits have a corresponding federal credit there would be an insignificant revenue loss of $1,800 ($50,000 x .40 receive federal credit x .09 marginal tax rate) beginning in 2021-22. These estimates of abandonment losses are based on estimates of the total FWHC, the percent that have federal credits, and the marginal tax rate.

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 loss to apply against other income.

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

Support/Opposition

According to the most recent policy committee analysis issued by the Assembly Revenue and Taxation Committee, organizations in support and opposition are as follows:

Support: Bill Lockyer, Treasurer; Association of California Life and Health Insurance Companies; Boston Capital; California Coalition for Rural Housing; California Rural Legal Assistance Foundation; and Centerline Capital Group

Opposition: None.

VOTES

Assembly Floor – Ayes: 78, Noes: 0
Senate Floor – Ayes: 25, Noes: 13
Concurrence – Ayes: 37, Noes: 1

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