**Franchise Tax Board**

# ANALYSIS OF AMENDED BILL

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| Author: | Romero | Analyst: | David Scott | Bill Number: | SB 1316 |
| Related Bills: | See Legislative History | Telephone: | 845-5806 | Amended Date: | April 22, 2010 |
| | | Attorney: | Patrick Kusiak | Sponsor: | |

**SUBJECT**: Low-Income Community Investment Credit/Non-recognized Gain Doesn't Include Out-of-State Property Exchanges

## SUMMARY

This bill would do the following:

**Provision 1**: Deny like-kind exchange treatment, where gains and losses are deferred on the transaction, for exchanges of California real property for out-of-state real property, and,

**Provision 2:** Provide a tax credit for investments in businesses that provide capital or loans to low-income communities.

## SUMMARY OF AMENDMENTS

The April 22, 2010, amendments removed legislative intent language related to the phase out of certain tax credits and added the provisions discussed in this analysis.

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

## PURPOSE OF THE BILL

The purpose of the bill appears to be to promote economic development, create wealth, and create job opportunities in low-income and high migration communities.

## EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2010.

## POSITION

Pending.

| Board Position: | | | Department Director | Date |
|---|---|---|---|---|
| _______ S | _______ NA | _______ NP | | |
| _______ SA | _______ O | _______ NAR | Selvi Stanislaus | 05/10/10 |
| _______ N | _______ OUA | ___X___ PENDING | | |

## ANALYSIS

### Provision 1: Elimination of Like-Kind Exchange Treatment for Outbound Exchanges

FEDERAL/STATE LAW

Current Federal Law

An exchange of property, like a sale, generally is an immediately taxable event. However, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like-kind" that is to be held for productive use in a trade or business or for investment.[1] If Internal Revenue Code (IRC) section 1031 applies to an exchange of properties, the basis of the property received in the exchange is equal to the basis of the property transferred, decreased by any money received by the taxpayer, and further adjusted for any gain or loss recognized on the exchange. In general, IRC section 1031 does not apply to any exchange of stock in trade or other property held primarily for sale; stocks, bonds or notes; other securities or evidences of indebtedness or interest; interests in a partnership; certificates of trust or beneficial interests; or choses in action.[2]

Current California Law

For taxable years beginning on or after January 1, 2010, California conforms to IRC section 1031 as of the specified date of January 1, 2009, relating to exchange of property held for productive use or treatment in Revenue and Taxation Code sections 18031 and 24941, with modifications.

THIS PROVISION

This provision would exclude from like-kind exchange treatment (non-recognition of gains or losses until the asset is disposed) for exchanges where non-California real property is received in exchange for California real property for taxable years beginning on or after January 1, 2010.

TECHNICAL CONSIDERATIONS

The word "purchased" is incorrectly used in Section 2; it should be "received" to keep with the IRC section 1031 nature of the transaction being an "exchange" rather than a taxable sale followed by a purchase. Amendment 6 is provided to correct.

### OTHER STATES' INFORMATION

Review of *Illinois, Michigan*, and *New York* laws found no comparable treatment of like-kind exchange property. These states were reviewed because of the similarities between California income tax laws and their tax laws.

[1] IRC section 1031(a)(1).
[2] IRC section 1031(a)(2).

**FISCAL IMPACT**

The additional costs have not been determined at this time, but will be developed as the bill moves through the legislative process.

**ECONOMIC IMPACT**

Revenue Estimate

| Estimated Revenue Impact of SB 1316<br>For Taxable Years Beginning On or After January 1, 2010<br>Assumed Enactment Date by September 30, 2010<br>($ in Millions) | | | |
|---|---|---|---|
| | **2010-11** | **2011-12** | **2012-13** |
| **Only Non-California Property Like-Kind Exchanges** | **$44** | **$38** | **$34** |
| **Qualified Community Development Entities (QCDE) Credit** | **-$52** | **-$64** | **-$72** |
| **QCDE credit would be limited to the gain generated by the Like-Kind Exchange provision.** | | | |

**ARGUMENTS/POLICY CONCERNS**

This provision would disallow gain deferral treatment of an exchange of out-of-state real property for California real property. This provision is likely to be subject to a constitutional challenge and should be expected to be interpreted by the courts as unlawful discrimination against out-of-state taxpayers under the commerce clause of the US Constitution.

**ANALYSIS**

**Provision 2: Qualified Equity Investment Credit**

FEDERAL/STATE LAW

Current Federal Law

A “new markets tax credit” (NMTC) is allowed for a taxpayer’s qualified equity investments to acquire stock or a similar equity interest in a community development entity (CDE). The CDE’s primary mission must be serving, or providing investment capital for, low-income communities or low-income persons as certified by the Secretary of the Treasury. The taxpayer’s federal NMTC totals 39 percent of the qualified equity investment made in the CDE but is spread over a seven-year period as follows:

- A 5 percent credit for the year the qualified equity investment is purchased and for the first two years thereafter (i.e., 15 percent for the first three years).
- A 6 percent credit for years four through seven (i.e., 24 percent for the subsequent four years).

Before a CDE can sell qualified equity investments eligible for the federal NMTC, it must apply for and be granted an allocation of NMTC from the Community Development Financial Institution Fund (CDFIF), a branch of the U. S. Department of the Treasury, through a competitive application and rigorous review process. Geographic diversity is not a consideration in the evaluation process.

Additional rules are provided that do all of the following:

- Require the taxpayer to reduce the basis of the equity investment by the amount of the credit.
- Allow the taxpayer to carry over to future years credits that are in excess of tax liability.
- Require the taxpayer to recapture credits previously utilized to reduce tax in the event that the CDE redeems the investment, the investment ceases to be used in the required manner, or the CDE ceases to be a qualified community development entity.

Current California Law

Although California does not conform to the federal NMTC, a 20 percent state credit is allowed for each "qualified investment" in a California "community development financial institution" (CDFI). Unlike the federal NMTC, the "qualified investment" in the California CDFI must be at least $50,000, be for a minimum duration of 60 months, and may consist of either of the following:

- A deposit or loan that does not earn interest.
- An equity investment.

A California CDFI is defined as a private financial institution located in California and certified by the California Organized Investment Network (COIN) that has community development as its primary mission and lends in urban, rural, or reservation-based communities in California. A CDFI includes a community development bank, a community development loan fund, a community development credit union, a micro-enterprise fund, a community development corporation-based lender, or a community development venture fund.

California law provides for a recapture of the CDFI credit if the "qualified investment" is reduced or withdrawn before the end of the 60-month period. This credit will cease to be operative for taxable years beginning on or after January 1, 2012.

THIS PROVISION

For taxable years beginning on or after January 1, 2010, this provision would allow a Qualified Equity Investment (QEI) credit over a nine-year period equal to a total of 51 percent of the amount of cash a taxpayer invests in a qualified community development entity (QCDE) under the Personal Income Tax and Corporation Tax laws.

The QCDE must meet all of the following criteria:

- Is a domestic corporation or partnership.
- Have as its primary mission serving or providing investment capital for low-income communities or low-income persons located in California.
- Maintain accountability to residents of low-income communities through representation on a governing board, an advisory board, or other similar community body.
- Is certified by the Treasurer as being a QCDE.

The aggregate amount of credits for any calendar year is capped at an amount equal to 100 percent of the aggregate revenue increase in the same calendar year as a result of the disallowance of like-kind exchange treatment, as specified in provision 1 of this bill. A QCDE is required to sell equity interests eligible for the state QEI credit to investors within five years of the date the entity receives an allocation from the FTB. Any amount not sold within that period is no longer eligible for the state QEI credit.

The provision defines the following terms:

- “Credit allowance date” means the date the investment is initially made and the six succeeding annual anniversary dates.
- “Equity investment” means any stock, other than nonqualified preferred stock, in a corporation, or any capital interest in a partnership.
- “Low-income community” means a population census tract where:
    - The tract has a poverty rate of at least 20 percent.
    - The tract is located in a non-metropolitan area where the median family income does not exceed 80 percent of the statewide median family income.
    - The tract is located in a metropolitan area where the median family income does not exceed 80 percent of the greater of the statewide median family income or the metropolitan area median family income.
    - The tract is located in a high migration rural county and the median family income does not exceed 85 percent of the statewide median family income. High migration rural county means a county which has a net migration out of least 10 percent over the past three censuses.

- “Qualified active low-income community business” means a corporation, including a nonprofit corporation, or partnership, or a business carried on by an individual that meets all of the following:
    - At least 50 percent of its total gross income is derived from the active conduct of a business in a low-income community.
    - Less than five percent of the average aggregate unadjusted base of property is attributable to collectibles, unless they are held for sale in the ordinary course of business.
    - A substantial portion of tangible property owned or leased by the business is used in a low-income community.

  - Less than five percent of the aggregate unadjusted base of the property is attributable to non-qualified financial property such as debt, stock, partnership interests, options, futures, forward contracts, warrants, notional principal contracts, annuities, or similar property.

- "Qualified business" means generally any trade or business in a low-income community including the rental of real property if there are substantial improvements located on the real property, with some exceptions for specific types of real property, "qualified equity investment" means any equity investment in a QCDE if all of the following are met:

  - The investment was acquired for cash at its original issue or subsequently.
  - Substantially all of the cash is used by the CDE to make investments in low-income communities. This requirement is deemed met if at least 85 percent of the assets of the CDE are invested in low-income community investments.
  - The investment is designated by the QCDE.

- "Qualified low-income community investments" means any of the following:

  - Any capital or equity investment in, or loan to, a qualified low-income community business.
  - Any capital or equity investment in, or loan to, a real estate project in a low-income community.
  - The purchase from another QCDE of a loan which is a qualified low-income community investment.
  - Financial counseling and other services in support of business activities or residents of low-income communities.
  - Any equity investment in, or loan to, a QCDE.

This provision provides additional rules that do all of the following:

- Require the taxpayer to recapture credits previously utilized to reduce tax if the QCDE redeems the investment, the investment ceases to be used in the required manner, and the QCDE ceases to be a qualified community development entity.
- Disqualify the business if the corporation repurchases its own stock.
- Allows for the transfer of a qualified equity investment.
- Allows the Treasurer to reallocate unused credits if not used within five years.

This provision does not provide for a carryover of unused credits by the taxpayer.
The FTB is required to issue regulations to carry out the purpose of the section, including regulations with criteria by which additional populations may be treated as low-income communities, the criteria by which entities are qualified active low-income community businesses, and rules to avoid abuse of the purposes of the section.

## IMPLEMENTATION CONSIDERATIONS

Department personnel are available to work with the author to resolve these concerns and any other issues that arise as the bill moves through the legislative process.

This provision defines “qualified active low-income community business.” The definition includes a provision that a substantial portion of the use of the tangible property of the entity, whether owned or leased, is within a low-income community. The provision does not define “substantial” for this clause, but does define substantial as being at least 85 percent for a different clause. Without specific rules, disputes between taxpayers and the department could arise.

This provision states that if an allocation of credits is not used within five years, it may be reallocated by the Treasurer. However, the provision says that the FTB is the department that makes the allocation of the credits. This appears to be a conflict and would need to be resolved.

This provision states that the credit shall be allocated by the FTB among taxpayers that apply for the allocation. The FTB shall give priority to applications submitted by entities that have a record of “successfully providing” capital or technical assistance to disadvantaged businesses or communities or entities that intend to make qualified low-income. There is no guidance of how to measure “successfully providing.” The FTB does not possess the expertise to make these decisions. Without specific rules, disputes between taxpayers and the department could arise.

This provision grants a credit over nine years in the amount of five percent for the first three credit allowance dates and six percent of the succeeding six credit allowance dates. However, the provision defines a credit allowance date as the date on which the initial investment is made and the six succeeding annual anniversaries, for a total of seven years. This would need to be resolved to administer the bill.

This provision states that the credit shall be allocated by the FTB among taxpayers that apply for the allocation. The amount that FTB is to allocate is to be based on the amount of revenue generated by the denial of like-kind exchange treatment for out-of-state real property for California real property in the same taxable year. There is no guidance how to allocate the credit.

## TECHNICAL CONSIDERATIONS

Amendment 1 is provided to change the “quality” to “qualified” to correspond to the definition.

Amendments 2 and 7 delete “active” from the definition because that phrase is not otherwise used in the bill.

Amendment 3 corrects a reference to the Internal Revenue Code.

Amendment 4 corrects the use of the plural, “investments,” when singular, “investment,” is the correct usage.

Amendment 5 deletes the phrase “amounts deducted” because no deduction is granted; credits are used.

## LEGISLATIVE HISTORY

AB 251 (Haynes, 2005/2006) would have provided a QEI credit that is the same as the credit provided by this bill. AB 251 failed to pass out of the Assembly Rules by the constitutional deadline.

AB 957 (Haynes, 2005/2006) would have provided a QEI credit that is the same as the credit provided by this bill. AB 957 failed to pass out of the Assembly Revenue and Taxation Committee by the constitutional deadline.

AB 411 (Haynes, 2003/2004) would have provided a California QEI credit over a seven-year period beginning in 2004. This bill failed to pass out of the Assembly Fiscal Committee by the constitutional deadline.

SB 1084 (Haynes, 2000/2001) would have conformed California law to the federal New Markets Credit. This bill failed to pass out of the Senate Policy Committee by the constitutional deadline.

AB 1591 (Leslie, 2000/2001) would have conformed California law to the federal New Markets Credit. This bill failed to pass out of the Senate Policy Committee by the constitutional deadline.

## OTHER STATES' INFORMATION

The states surveyed include *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. Those states do not allow a credit comparable to the credit proposed by this provision. However, those states do provide either enterprise zone tax incentives in economically depressed areas or financial incentives (i.e., industrial development bonds, infrastructure loans and grants, venture capital funds, and other community development assistance programs) to promote community development.

## FISCAL IMPACT

This provision would require the FTB to do a calculation of the amount of available credit for each year, a computation of the allocation of the available credits each year, and to implement a review process of the applications submitted for the credit allocation. As a result, this provision would impact the department's printing, processing, and storage costs. The additional costs have not been determined at this time, but will be developed as the bill moves through the legislative process and implementation considerations are resolved. It is recommended that the bill be amended to include appropriation language that would provide funding to implement this bill. Lack of an appropriation will require the department to secure the funding through the normal budgetary process, which could delay implementation of this bill.

**ECONOMIC IMPACT**

Revenue Estimate

**See above revenue table on page 3.**

Revenue Discussion

**LEGAL IMPACT**

Federal law prohibits discriminatory state taxation of interest on federal securities. This bill would allow a credit investment in entities that make loans to entities engaged in a trade or business in low-income communities. This incentive, which provides an indirect subsidy to non-federal loans, could be considered to result in a violation of the federal law prohibiting discriminatory state taxation of interest on federal securities.

**ARGUMENTS/POLICY CONCERNS**

This bill lacks a sunset date. Sunset dates generally are provided to allow periodic review of the effectiveness of the credit by the Legislature.

This bill lacks carryover language. As a result, any unused credit would be lost if the taxpayer is unable to use the entire credit amount in the year claimed. The author may wish to add language allowing a limited carryover period.

The bill's criteria that a corporation must be a domestic corporation (to be a QCDE) may present constitutional concerns by discriminating against foreign commerce if the term "domestic" means "U.S.", or by discriminating against interstate commerce if the term "domestic" means "California" (as would be the case if Corporations Code definition applies). This same issue arises under "S" corporation rules as well.

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FRANCHISE TAX BOARD’S
PROPOSED AMENDMENTS TO SB 1316
As Amended on April 22, 2010

AMENDMENT 1

On page 2, line 16, strikeout “quality” and insert:

qualified

AMENDMENT 2

On page 3, line 19, strikeout “active”

AMENDMENT 3

On page 5, line 12, strikeout “1203(c)(3)” and insert:

1202(c)(3)

AMENDMENT 4

On page 5, line 14, strikeout “investments” and insert:

investment

AMENDMENT 5

On page 6, line 12, strikeout “amounts deducted” and insert:

credits used

AMENDMENT 6

On page 6, line 33, strikeout “purchased” and insert:

received

AMENDMENT 7

On page 8, line 7, strikeout “active”

AMENDMENT 8

On page 11, line 22, strikeout “purchased” and insert:

received