SUMMARY ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Romero | Analyst: David Scott | Bill Number: SB 1316

Related Bills: See Prior Analysis | Telephone: 845-5806 | Amended Date: June 16, 2010

Attorney: Patrick Kusiak | Sponsor:

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

X DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as amended April 22, 2010.

____ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

X AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as amended April 22, 2010.

____ FURTHER AMENDMENTS NECESSARY.

____ DEPARTMENT POSITION CHANGED TO ____________________.

X REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED April 22, 2010, STILL APPLIES.

X OTHER – See comments below.

SUMMARY

This bill would do the following:

- *Provision 1:* This provision would provide a California New Markets Tax credit for investments in businesses that provide capital or loans to low-income communities.

- *Provision 2:* This provision would deny non-recognition treatment for like-kind exchanges, where gains and losses are deferred on the transaction, for exchanges of California real property for out-of-state real property.

SUMMARY OF AMENDMENTS

The June 16, 2010, amendments did the following:

- Reduced the number of years a taxpayer can receive the California New Markets Tax credit from nine years to seven years.
- Changed the responsibility for the administration of the California New Markets Tax credit from the Franchise Tax Board (FTB) and the Treasurer to the Treasurer.

Board Position:			Legislative Director	Date
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- Changed the operative date from taxable years beginning on or after January 1, 2010, to January 1, 2011.
- Defined “substantial portion” for the required use of property in the low-income community to mean 40 percent or more of the entity’s tangible property.
- Eliminated the exception for collectibles inventory available for sale from the requirement that less than five percent of the average of the aggregate unadjusted base of property is for collectibles.

As a result of the amendments, the “Implementation Considerations” and “Technical Concerns" discussed in the department’s analysis of the bill as amended April 22, 2010, have been resolved. A new implementation concern has been identified. The “This Bill,” “Implementation Considerations,” and “Revenue Estimate” discussions have been revised. The remainder of the department’s analysis of the bill as amended April 22, 2010, still applies. The Legal Impact and Arguments/Policy Concerns discussions are repeated for convenience.

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, 2011.

POSITION

Pending.

ANALYSIS

Provision 1: 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.

<u>THIS PROVISION</u>

For taxable years beginning on or after January 1, 2011, this provision would allow a credit for a qualified equity investment (QEI) over a seven-year period equal to a total of 39 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 2 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 that 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.

- A substantial portion (at least 40 percent) 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, or 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 Treasurer 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 CONSIDERATION

The provision requires that the FTB certify the aggregate revenue increase from the disallowance of the deferred gain treatment on like-kind exchanges for a calendar year. The provision also says that the credits for a calendar year will be based on the certified revenue increase for the same calendar year. The certification could not be done until at least 18 months after the credit allocation is to be supposed to be made because of the timing of taxpayers filing, time to process the return, and then analyze the information. As a result, the timing of the credit allocation and the revenue certification would not match as required in the bill. This concern would be eliminated if the FTB were allowed to estimate the revenue increase, rather than certify the revenue increase.

Provision 2: 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.

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

THIS PROVISION

This provision would exclude from like-kind exchange treatment (non-recognition of gains or losses until the asset is ultimately disposed of) for exchanges where non-California real property is received in exchange for California real property for taxable years beginning on or after January 1, 2011.

OTHER STATES' INFORMATION

Prior to 2001, Oregon limited non-recognition treatment for transactions involving in-state replacement property only. In *Wilson v. Department of Revenue*, the Oregon Supreme Court considered the constitutionality of limiting the non-recognition treatment. The statute was repealed in 2001. Georgia and Mississippi had similar statutes. Both have been amended or repealed to remove the limitation to in-state transactions only.

FISCAL IMPACT

This provision would require the FTB to certify the amount of available credit for each year. 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.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of SB 1316 Amended June 16, 2010 For Tax Years Beginning On or After January 1, 2011 Assumed Enactment Date By September 30, 2010 ($ in Millions)			
	2010-11	**2011-12**	**2012-13**
Provision 1-Qualified Community Development Entities (QCDE) Credit	**-$25**	**-$70**	**-$72**
Provision 2-Only Non-California Property Like-Kind Exchanges	**$13**	**$37**	**$44**
QCDE credit would be limited to the gain generated by the Like-Kind Exchange provision			

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 issue also arises under "S" corporation rules.

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