Franchise Tax Board

# ANALYSIS OF AMENDED BILL

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| Author: | Cedillo | Analyst: | Gail Hall | Bill Number: | SB 767 |
| Related Bills: | See Legislative History | Telephone: | 845-6111 | Amended Date: | March 31, 2009 |
| | | Attorney: | Patrick Kusiak | Sponsor: | |

SUBJECT Prohibit Tax Credits & Deductions For Taxpayer's That Receive Troubled Assets Relief Program (TARP) Funding

## SUMMARY

This bill suspends the usage of credits that reduce tax and certain deductions that reduce income for corporations that participate in the federal program called TARP.

## SUMMARY OF AMENDMENTS

The March 31, 2009, amendments removed provisions relating to the Government Code and added provisions relating to suspension of certain corporation tax credits and specific deductions.

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

## PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to prohibit corporations that unnecessarily receive federal bailout monies from receiving tax benefits from the state during the bailout period.

## EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and would be specifically operative for taxable years beginning on or after January 1, 2009.

## POSITION

Pending.

## PROGRAM BACKGROUND

The Emergency Economic Stabilization Act (EESA) of 2008 (Public Law 110-343) was signed into law on October 3, 2008, during a time of tremendous financial upheaval and economic uncertainty. TARP was established under EESA with the specific goal of stabilizing the United States financial system and preventing a systemic collapse. The U.S. Treasury Department (Treasury) has established several programs under TARP to stabilize the financial system. The name and brief description of the various TARP programs are listed in Appendix A.

| Board Position: | | | Department Director | Date |
|---|---|---|---|---|
| _______ S | _______ NA | _______ NP | | |
| _______ SA | _______ O | _______ NAR | Selvi Stanislaus | 05/20/09 |
| _______ N | _______ OUA | ___X___ PENDING | | |

## ANALYSIS

### FEDERAL/STATE LAW

Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

Current state law provides a qualified taxpayer a deduction of net interest income for loans made to a trade or business located solely within a designated Enterprise Zone. In addition, a taxpayer engaged in a trade or business within an Enterprise Zone may elect to treat 40 percent of the eligible cost of purchasing qualified property as a current deduction rather than a capital expenditure deducted over a specified number of years.

For taxable years ending after October 2, 2008, federal law provides that the deduction for compensation paid to executives is limited to $500,000 for financial institutions from whom troubled assets are acquired under TARP[1]. California does not conform to this provision.

### THIS BILL

This bill would provide that all credits under the Corporation Tax Law (CTL), including carryover credits from prior years, and the net interest deduction and 40 percent deduction for property relating to Enterprise Zone provisions, would be suspended for a taxpayer that is a participant in TARP for any taxable year during the period of participation. The bill would provide that participation in TARP begins upon receipt of financial assistance of any amount from the Treasury, and ends when the total amount of financial assistance received has been returned to the Treasury.

In addition, the bill would provide the following provisions:

- Credits otherwise allowable and credit carryforward periods are increased by the number of taxable years during which the credit was suspended.
- Deductions suspended during TARP participation are allowed after participation ends.

### IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these concerns and any other concerns that may be identified.

1. This bill could result in a record keeping burden for taxpayers and the department because the records for the suspended tax credits and Enterprise Zone deductions may need to be retained for many years passed the normal carryover periods.

2. For the department to verify a taxpayer's compliance with the provisions of this bill, a listing of TARP participants and the date the participation begins and ends would need to be available or provided to the department for proper enforcement.

[1] Internal Revenue Code section 162(m)(5).

## LEGISLATIVE HISTORY

There has been no previous legislation relating to TARP.

## OTHER STATES' INFORMATION

The laws of *Florida*, *Illinois*, *Massachusetts*, *Michigan*, *Minnesota*, and *New York* were reviewed because their tax laws are similar to California's income tax laws. Research found these states have no provisions similar to SB 767.

## FISCAL IMPACT

This bill would suspend TARP participants from utilizing tax credits and certain deductions until subsequent years. As a result, this bill would impact the department's audit process, tax forms and instructions, and storage costs for maintaining records of suspended items. The additional costs have not been determined at this time. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

## ECONOMIC IMPACT

### Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following individual and corporate income tax revenue gains under the CTL:

| Estimated Revenue Impact of SB 767 as Amended on 3/31/09<br>For Taxable Years Beginning On or After 1/1/09<br>Enactment Assumed After 6/30/09<br>($ in Millions) | | | |
|---|---|---|---|
| Fiscal Year | 2009-10 | 2010-11 | 2011-12 |
| Revenue Gain | +$36 | +$50 | +$48 |

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

### Revenue Discussion

The revenue impact depends on the number of TARP participants that pay corporation franchise/income taxes to California, the extent to which these corporations generate and use tax credits and deductions that would be suspended, and the ability of participants to repay the bailout money over time.

Based on data obtained from the Government Accountability Office and a ProPublica, a non-profit journalism organization, 532 TARP participants have received over $330 billion in bailout monies as of April 3, 2009. Of the 532 participants, a sample of 28 participants subject to California tax were selected based primarily on the amount of TARP money received. The sample group represents approximately 88 percent of the $330 billion in total TARP money disbursed as of April 3, 2009.

For the 2005 and 2006 taxable years, the sample's 28 participants utilized an average of $38.8 million in state corporation tax credits. In addition, the net interest and business expenses deductions reduced the tax liability of the sample's 28 participants by approximately $11.7 million. This bill would have suspended approximately $50.5 million ($38.8 + $11.7) in tax benefits if it had been applicable to the 2005 and 2006 tax years.

The estimated revenue gain from the suspension of tax credits and deductions for taxable year 2009 is $38.2 million. The reason the revenue gain decreased from $50.5 million (2005 and 2006) to $38.2 million for 2009 is that the amount of the participant's state income is projected to decrease due to the poor economic conditions in 2008 and 2009. It is estimated that for 2010, the amount of suspended credits and disallowed deductions would result in an approximate $42 million revenue gain reflective of an estimated 10 percent increase in profits among the TARP participants. [($38.2 + ($38.2 x 10%)]. For 2011, the amount of suspended credits and disallowed deductions would result in a $50.4 million revenue gain reflective of an estimated 20 percent increase in profits among the TARP participants. [$42 + ($42 x 20%)].

The $38.2 million revenue gain for the 2009 taxable year is reduced by $14.7 million because of current law's 50% limitation on the use of business tax credits,[2] lowering the potential revenue gain from the suspension of credits and deductions to $23.5 million for taxable year 2009.

Taxable year estimates are converted to fiscal year cash flows and shown in the table above. For example, the $36 million revenue gain for fiscal year 2009/2010 includes approximately $21 million of the estimated $23.5 million of revenue gain from taxable year 2009, along with an additional $15 million in increased estimated tax payments from taxable year 2010.

As corporations repay monies and end their participation in TARP, there would be revenue losses that offset most of these revenue gains as corporations begin using suspended tax credits and deductions. It is estimated that corporations could end their participation in TARP as early as taxable year 2012.

## LEGISLATIVE STAFF CONTACT


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[2] Revenue and Taxation Code section 23036.2

APPENDIX A
TARP Programs
(According To The U.S. Treasury's Financial Stability Website[3])

Capital Assistance Program – Ensure Banks Have Adequate Capital
Treasury has announced details of its Capital Assistance Program to restore confidence in our financial institutions and ensure that they have the capital to continue to lend even in a more adverse environment. The supervisors are conducting stress tests of the nation's major financial institutions to determine whether they need additional capital to continue lending and absorb the potential losses that could result from a more severe decline in the economy than projected. Eligible financial institutions can either raise the necessary capital in the private markets, or issue convertible preferred stock to the government through CAP.

Consumer and Business Lending Initiative – Unfreeze Secondary Credit Markets
Under the CBLI, the Treasury and the Federal Reserve are working together to provide an initial $200 billion in financing to private investors to help unfreeze and lower interest rates for loans for students, small businesses, and others. This program has the potential to unlock up to $1 trillion of new lending and unfreeze currently frozen credit markets.

Making Home Affordable Program – Help Families Stay in Their Homes
The Making Home Affordable Program will help up to 5 million responsible homeowners refinance to keep their mortgages affordable, and create a $75 billion loan modification program to help up to 4 million families avoid foreclosure. The plan establishes guidelines to help bring order and consistency to the home loan process and keep more American families in their homes.

Public-Private Investment Program – Addressing the Challenge of Legacy Assets
To address the challenge of legacy assets, Treasury – in conjunction with the Federal Deposit Insurance Corporation and the Federal Reserve – has created the Public-Private Investment Program as part of its efforts to repair balance sheets throughout our financial system and ensure that credit is available to the households and businesses, large and small, that will help drive us toward recovery.

Capital Purchase Program
The Capital Purchase Program (CPP) is a voluntary program in which the U.S. Government, through the Department of Treasury, invests in preferred equity securities issued by qualified financial institutions. Participation is reserved for viable institutions that are recommended by their federal banking regulator. Treasury's intent is to provide immediate capital to stabilize the financial and banking system, and to support the economy. It is vital that lending be available to families and businesses that need access to credit, to pay for college or to invest and create jobs. A necessary precursor to lending and economic recovery is a stable, healthy financial system.

Asset Guarantee Program
Under the Asset Guarantee Program (AGP), Treasury will guarantee certain assets held by the qualifying financial institution. The set of insured assets is selected by the Treasury and its agents in consultation with the financial institution receiving the guarantee. In accordance with section 102(a), assets to be guaranteed must have been originated before March 14, 2008.

Targeted Investment Program
Treasury created the Targeted Investment Program (TIP) to stabilize the financial system by making investments in institutions that are critical to the functioning of the financial system. This program focuses on the complex relationships and reliance of institutions within the financial system. Investments made through the TIP seek to avoid significant market disruptions resulting from the deterioration of one financial institution that can threaten other financial institutions and impair broader financial markets and pose a threat to the overall economy. Through the TIP, Treasury is working to stabilize the financial system by reducing the chance that one firm's distress will threaten otherwise financially-sound businesses, institutions, and municipalities, which could cause an adverse spillover effect on employment, output, and incomes.

Automotive Industry Financing Program
The objective of this program is to prevent a significant disruption of the American automotive industry that poses a systemic risk to financial market stability and will have a negative effect on the economy of the United States. The program will require steps be taken by participating firms to implement plans that achieve long-term viability.

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[3] http://www.financialstability.gov/roadtostability/programs.htm