Franchise Tax Board

SUMMARY ANALYSIS OF AMENDED BILL

Author: Lowenthal | Analyst: Angela Raygoza | Bill Number: SB 16

Related Bills: See Prior Analysis | Telephone: 845-7814 | Amended Date: January 8, 2009

Attorney: Patrick Kusiak | Sponsor:

SUBJECT: Low Income Housing Refundable Credit

____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended ___________________.

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

____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENTS CONCERNS stated in the previous analysis of bill as introduced/amended ____________________.

____ FURTHER AMENDMENTS NECESSARY.

____ DEPARTMENT POSITION CHANGED TO ____________________.

X REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED December 1, 2008, STILL APPLIES.

X OTHER – See comments below.

SUMMARY

This bill would make the Low Income Housing Credit (LIHC) refundable, as specified.

SUMMARY OF AMENDMENTS

The January 8, 2009, amendments would do the following:

- Extend the partnership allocation rules,
- Extend the expiration date of the refundable LIHC to projects that received a preliminary reservation, from January 1, 2010 to January 1, 2011, and
- Define “financial closing.”

As a result of the amendments, the “Effective/Operative Date,” “This Bill,” “Implementation Concerns,” and “Revenue Impact” discussions, as provided in the department’s analysis of the bill as introduced, December 1, 2008, have been revised. The amendments resolve one of the implementation concerns, but a new concern has been identified along with the remaining implementation concerns that were identified in the department’s analysis dated December 1, 2008. The “Fiscal Impact” and “Policy Concerns” have been included below for convenience.

Board Position:			Assist. Legislative Director	Date
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EFFECTIVE/OPERATIVE DATE

As an urgency measure, this bill would be effective immediately upon enactment. The language specifies that the provisions related to the special allocation rules would be specifically operative for projects that receive a preliminary reservation during calendar year 2008 for which financial closing has not occurred as of the effective date. The provisions that would make the LIHC refundable are specifically operative for projects that receive a preliminary reservation on or after July 1, 2008, and before January 1, 2011.

ANALYSIS

THIS BILL

This bill would allow projects that receive a preliminary reservation of the state LIHC during calendar year 2008, for which financial closing has not occurred by the effective date of the bill, to be allocated to the partners of a partnership owning a low-income housing project. In accordance with the 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].

In addition, 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 that the federal credit is allowed.

This bill would allow the LIHC to be refundable for projects that have received a preliminary reservation for a state low-income housing tax credit on or after July 1, 2008, and before January 1, 2011.

Under this bill, “financial closing” is defined as the date the deeds of trust for all construction financing have been recorded or, if no construction lender is involved, the equity partner has been admitted to the ownership entity. The provisions of this bill would not apply if a “financial closing” has occurred prior to the effective date of this bill.

Currently, the Tax Credit Allocation Committee (TCAC) allocates the LIHC to the taxpayer; the credit is applied to reduce taxes owed, and any remaining amount is carried over to reduce taxes in future years. Under this bill, after applying the credit to reduce taxes owed, the excess amount would be refundable. The refunds would be made after all tax liabilities, including, tax, penalties, interest, and fees, have been paid. The refundable amounts determined by FTB would be transferred from the Personal Income Tax Fund or Corporation Income Tax Fund to the Tax Relief and Refund Account. These funds are General Fund accounts.

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

IMPLEMENTATION CONSIDERATIONS

The remaining implementation concerns from the December 1, 2008, analysis are listed below. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

This bill could be interpreted to allow any unused LIHC to be refunded and carried forward. Because this bill is making the LIHC refundable, any unused credit would be refunded to the taxpayer in the same taxable year the credit is claimed. To prevent this interpretation, the author may wish to amend the bill to prevent this result and eliminate ambiguity.

This bill is silent regarding whether this refundable business tax credit could be assigned. Beginning on or after July 1, 2008, a taxpayer that is a member of combined reporting group can assign business tax credits to taxpayers within that group. Assigned credits can only be applied to reduce a tax liability in taxable years beginning on or after January 1, 2010. Consequently, under existing law any assigned refundable credit would not be refundable until taxable years beginning on or after January 1, 2010. The absence of clarity could lead to disputes with taxpayers and would complicate the administration of this credit.

The January 8, 2009, amendments raise additional implementation concerns, as follows:

This bill uses terms that are undefined or without clear definition regarding the operative date of the provision, i.e., "the equity partner," "admitted," "ownership entity," "construction financing," and "recorded." The absence of definitions to clarify these terms could lead to disputes with taxpayers and would complicate the administration of this credit.

FISCAL IMPACT

This would be the first time the department has administered a refundable tax credit under the Corporation Tax Law (CTL). Staff estimates a combined a one-time cost of approximately $521,000 (4.3 PYs) to develop, program, and test the refundable credit processes in existing systems for both personal income tax and corporation tax. In addition, staff estimates ongoing costs of approximately $14,000 to validate the credits reported on the tax return against pre-approved information from the TCAC.

ECONOMIC IMPACT

Revenue Estimate

Refundable Low-Income Housing Credit Effective On or After ($ in Millions)			
Fiscal Year	2011-12	2012-13	2013-2014
Refundable Low-Income Housing Credit*	-$0.2	-$1.8	-$6.2

*Over an eight-year period starting with fiscal year 2012-13 and ending with fiscal year 2019-20, the revenue impact of this bill would be revenue neutral.

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

Revenue Discussion

Special Partnership Allocation Applied to 2008[2]

The revenue impact of the special partnership allocation being applied to preliminary reservations of state LIHC made during calendar year 2008 is dependent on the increase in the rate at which those tax credits would be utilized (applied against state tax liabilities). The estimate assumes that state credits generated for eligible projects would experience a 25% faster utilization if allowed to be allocated separately from the federal credits.

This estimate relies on a residual credit value that was determined by analyzing historical data to compare credits allocated in one year and later applied against tax liabilities. Any amounts remaining after the four-year credit window was considered residual. This estimate reflects a three-year lag from preliminary credit reservation to the time when final project certification occurs by the TCAC. The initial revenue loss impact occurring in fiscal year 2011-12 represents approximately 25% of a projected credit residual of $2.7 million. Based on TCAC data, this loss is spread over the four-year credit window. An estimated $200,000 more of LIHC reserved during 2008 would be applied against tax liabilities over the four-year credit period, starting in 2011-12 ($2.7M x 25% increased utilization x 27%[3] share in year 1 of 4 ≈ $200,000). This $200,000 revenue loss pattern continues for the next two fiscal years, as shown in the table. In the fourth fiscal year, 2014-15, the cash flow revenue loss would be reduced by approximately $50,000 because fewer credits would be distributed in the last year of the applicable four-year LIHC window.

Finally, in fiscal year 2022-23, it was assumed state LIHC recipients would realize additional revenue losses from the abandonment of a partnership interest. The amount of the corresponding revenue loss is estimated at approximately $250,000. This amount represents taxes reduced by the deduction of abandonment losses by investors whose only tie to the partnership was the state LIHC. This revenue loss is computed from the estimated portion of 2008 preliminary credits (approximately $3 million of the $84 million credit ceiling) that are deemed allocated to investors who would walk-away after the requisite ten-year period specified under current law. As such, it is assumed taxpayers would claim abandonment losses of $3 million and a revenue loss of approximately $250,000 would result ($3 million x 8.84% tax rate).

[2] SB 585 (Stats. 2008, Ch.382) was enacted to allowed special partnership allocation rules for the LIHC.
[3] Percentages as referenced in step #4.

Extend Refundable Low Income Housing Credit through 2010

The revenue impact of making the LIHC refundable is dependent on the amount of LIHC refunded or applied to reduce tax liabilities under the proposal that otherwise would be applied several years later under current law. Relative to current law, more credits would be used sooner under the bill, offset by fewer credits claimed in later years.

Under current law, the analysis assumes that a significant percentage of preliminary credit reservations made during the specified 30-month period would be subsequently returned. Absent state legislation, it is assumed these returned credits would not be awarded until several years later when investor demand for low income housing projects returns to historical levels.

Estimates were derived in the following steps:

1. Projected the LIHC awarded by the TCAC based on credits available annually under the state LIHC program for 2008 through 2010:

   Annual state credits available to be awarded are $83.8 million for 2008, $85.0 million for 2009, and $87.0 million for 2010. Based on TCAC data, available credits are multiplied by 96% to reflect the amounts that are awarded, resulting in $80.4 million for 2008 ($83.8 million x 0.96 ≈ $80.4 million), $81.6 million for 2009, and $83.5 million for 2010.

2. Adjusted the amount of awarded LIHC to reflect only eligible refund amounts:

   According to TCAC data, 72% of the 2008 preliminary reservations were made after 7/1/2008. Based on TCAC data, a 50% reduction adjustment is applied to eliminate projects for which a “financial closing” of a preliminary reservation occurs before 6/30/2009. Therefore, approximately $29 million in credits would be potentially subject to refund under the bill ($80.4 million x 72% second round x 50% not yet “closed” by 6/30/2009 ≈ $29 million).

3. Projected the relevant amount of LIHC that would be awarded under current law, adjusted to account for the current economic downturn:

   Based on historical data, it is assumed that under <u>current</u> law, 20% of the preliminary credits reserved would be returned and awarded in subsequent years, starting with 2011. This reduces the potential base amount of final awards associated with the 2008 year to approximately $23 million ($29 million x .80).

4. Calculated the difference in applied credits under the bill and current law:

   Consistent with prior estimates, it is assumed there would be a four-year lag between the preliminary credit reservations in 2008 and when the credit is finally awarded in 2012. Of annual credits awarded, almost all are applied to reduce tax liabilities during the four-year credit period: 27% in each of the first three years (2012, 2013, and 2014) and the remaining 19% in the fourth year (2015).

The amount of 2008 preliminary credit reservations eligible for refund starting in 2012 is approximately $29 million. Of the $29 million assumed fully awarded, the amount that can be applied in the first year of the four-year credit period, 2012, is $7.8 million (27% x $29 million ≈ $7.8 million). Under current law, of the economically adjusted $23.2 million of awarded credits originating from 2008, the amount projected to be applied in 2012 is $6.2 million (27% x $23.2 million ≈ $6.2 million). The difference in applied credits under these two scenarios is $1.6 million ($7.8 million - $6.2 million).

The fiscal impact primarily results from the difference between 100% demand for available credits generated by this bill and only 80% demand for available credits under conditions of current law. Given the current economic downturn, the underlying assumption is that demand for these credits has decreased by 20%. It is anticipated that demand for LIHC would be restored to historical levels, causing more credits to be used sooner (i.e., refunded or applied to reduce tax liabilities).

Because taxpayers would not report refundable credits until the tax return for 2012 is filed, the entire $1.6 million of the initial fiscal year impact does not occur until 2012-13. Under the same methodology as described above, the revenue losses would be approximately $6 million in 2013-14, $10.5 million in 2014-15, $8.5 million in 2015-16, and $1.7 million in 2016-17. Relative to current law, more credits would be claimed sooner under proposed law, offset by fewer credits claimed in later years. Starting in 2017-18, there would be revenue gains that offset the prior years' losses.

POLICY CONCERNS

The department is concerned with the possibility of fraud. Historically, refundable credits (such as the state renter's credit, the federal Earned Income Credit, and the federal credit for gasoline used for farming) have had significant problems with invalid and fraudulent returns. Although the LIHC would be verified by a third party, the TCAC, at the partnership entity level, the possibility of fraud remains at the partner level when a personal income tax return is filed by a partner.

In addition, this bill would set a precedent for business tax credits by allowing the LIHC to be refundable under the CTL.

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