Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Lowenthal	Analyst:	Angela Raygoza	Bill Number:	SB 16
Related Bills:	See Legislative History	Telephone:	845-7814	Introduced Date:	December 1, 2008
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Refundable Low-Income Housing Credit

SUMMARY

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

PURPOSE OF THE BILL

The bill language addressing the reasons for urgency indicates that the purpose of this bill is to prevent low-income housing project developers from returning unused credits because of the financial downturn and to entice investors back into affordable housing until the financial market stabilizes.

EFFECTIVE/OPERATIVE DATE

As an urgency measure, this bill would be effective immediately upon enactment and specifically operative for projects that have received or receive a preliminary reservation on or after July 1, 2008, and before January 1, 2010.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Current federal tax law allows a LIHC for the costs of constructing, rehabilitating, or acquiring low-income housing. The credit amount varies–dependent 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 and state credit.

Board Position:			Department Director	Date
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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 year 2009, the amount of LIHC available is $85 million.[1]
- The unused housing credit ceiling, if any, for the preceding calendar year.
- The amount of housing credit ceiling returned in the current 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
- The allocation of income, gain, loss, deduction, or credit to a partner under the partnership agreement does not have substantial economic effect.

As an exception to the requirements above, under state tax law, for a project that receives a preliminary reservation of the LIHC on or after January 1, 2009, and before January 1, 2016, the LIHC may be allocated to the partners of a partnership owning a low-income housing project in accordance with the provisions of 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, within the meaning of Internal Revenue Code section 704(b) [2].

In addition, state tax law requires a deferral of any loss or deduction from the sale or disposition of a partnership interest where the LIHC was allocated without substantial economic effect to be deferred until the first taxable year immediately following the end of the ten-year credit period for which the federal credit is allowed.

The existing federal and state LIHCs are non-refundable.

Under current state law, Corporation Tax Law allows the assignment of certain credits to taxpayers that are members of a combined reporting group and adds the following provisions:

- Provides that an "eligible credit" may be assigned by a taxpayer to an "eligible assignee."
  - "Eligible credit" means any credit earned by a taxpayer in a taxable year beginning on or after July 1, 2008, or any credit earned in any taxable year beginning before July 1, 2008, which is eligible to be carried forward to the taxpayer's first taxable year beginning on or after July 1, 2008.
  - "Eligible assignee" means any "affiliated corporation" that is a member of a combined reporting group at certain specified times.
  - "Affiliated corporation" means a corporation that is a member of a combined reporting group.

[1] This amount is adjusted annually based on the Consumer Price Index (CPI) for the preceding calendar year.
[2] Internal Revenue Code section 704 (b) defines a partner's distributive share with respect to substantial economic

- Provides that the election to assign any credit is irrevocable once made and is required to be made on the taxpayer's original return for the taxable year in which the assignment is made.

In nonprecedential legal advice recently made available to the public,[3] the Internal Revenue Service (IRS) has indicated that refundable state business credits are taxable. Because state law conforms to the federal tax law in this area, absent state legislation, a refundable credit would also be considered taxable for state purposes.

THIS BILL

This bill would make the LIHC 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, 2010. For a preliminary reservation that would qualify under the preceding sentence, except that the financial closing occurred on or after July 1, 2008, and before December 31, 2008, the provisions of this bill would not apply.

Currently, the TCAC allocates the LIHC to the taxpayer. Under this bill, the TCAC would continue to allocate the state LIHC to the taxpayer, but require the refundable LIHC amounts to be determined by FTB. The refunds would be made after all liabilities 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.

IMPLEMENTATION CONSIDERATIONS

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

This bill uses a term that is undefined, i.e., "financial closing." The absence of definitions to clarify this term could lead to disputes with taxpayers and would complicate the administration of this credit.

This bill would allow any unused LIHC to be 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. As a result, it would appear that the carryover language is unnecessary. The author may wish to amend the bill to remove the carryover provision to eliminate confusion.

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.

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[3] Legal Advice issued by Filed Attorney 20085201F dated December 30, 2008.

LEGISLATIVE HISTORY

SB 585 (Stats. 2008, Ch. 385) requires a project that receives a preliminary reservation of the LIHC on or after January 1, 2009, and before January 1, 2016, to have the LIHC 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 under Internal Revenue Code section 704(b) of the. In addition, SB 585 requires 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 for which the federal credit is allowed.

SB 1247 (Stats. 2008, Ch. 521) repealed the farmworker housing credit from the Revenue and Taxation Code and requires the FWHC to be allocated in the same manner as the state low-income housing tax credit. This act specifies that the $500,000 annual cap plus any unallocated credit under current law is exclusively for farmworker housing. SB 1247 allows any Farmworkers Housing Credit (FWHC) that is unallocated or returned to be added to the annual credit allocation cap until exhausted. This act also allows the FWHC to be awarded independently of the federal LIHC.

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 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

<u>Revenue Estimate</u>

Refundable Low-Income Housing Credit Effective On or After November 30, 2008 ($ in Millions)			
Fiscal Year	2011-12	2012-13	2013-2014
Refundable Low-Income Housing Credit*	No impact	-$1.6	-$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

Estimates were derived in the following steps:

1. Projected the amount of LIHC awarded by the TCAC based on credits available annually under the state LIHC program for 2008 and 2009.

   Annual state credits available to be awarded are $83.8 million for 2008 and $85.0 million for 2009. 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) and $81.6 million for 2009 ($85.0 million X 0.96 = $81.6).

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

   According to TCAC data, 72% of the 2008 preliminary reservations were made after July 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 December 31, 2008. Therefore, approximately $29 million in credits would be potentially subject to refund under the bill ($80.4million x 72% second round x 50% not yet "closed" by 12/31/08 ≈ $29 million).

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

   Based on historical data, it is assumed that under current 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 $23.1 million ($28.9 million x .80).

4. Calculated the difference in applied credits under this 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 would be 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 $28.9 million. Of the $28.9 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 $28.9 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). It is assumed that the refundable credits would drive a change in the demand for available credits; 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 the 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%. Under the proposed law, 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 would not occur until 2012-13. There would be revenue losses of $6 million in 2013-14, $6 million in 2014-15, and $4 million in 2015-16. Relative to current law, more credits would be claimed sooner under proposed law, offset by fewer credits claimed in later years. Thus, there will be revenue losses from 2012-13 through 2015-16; 98% of these losses will be offset by revenue gains from 2016-17 through 2019-20.

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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