**Franchise Tax Board**

# ANALYSIS OF AMENDED BILL

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| Author: | Davis and Perez | Analyst: | David Scott | Bill Number: | AB 643 |
| Related Bills: | See Legislative History | Telephone: | 845-5806 | Amended Dates: | January 4, 2012, and January 12, 2012 |
| | | Attorney: | Patrick Kusiak | Sponsor: | |

**SUBJECT**: New Jobs Tax Credit Modification/California New Markets Tax Credit

## SUMMARY

This bill would do the following:

- Reduce the total amount of the New Jobs Tax Credit that may be claimed for all taxable years; and
- Provide a new tax credit for investments in businesses that provide capital or loans to low-income communities.

## RECOMMENDATION AND SUPPORTING ARGUMENTS

No position.

### Summary of Amendments

The January 4, 2012, amendments removed provisions related to mortgage counseling. The amendments added provisions that would reduce the allocation amount for the existing New Jobs Tax Credit and would create a new income tax credit for investments in specified businesses.

The January 12, 2012, amendments added criteria to the guidelines for the tax credit allocation process and allowed "start-up businesses" to be considered as a "qualified active low-income community business." The amendments also added an author.

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

## PURPOSE OF THE BILL

The purpose of this bill is to stimulate economic development and hasten California's economic recovery by granting tax credits for investment in California, including, but not limited to, retail businesses, real property, financial institutions, and schools.

## EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and has two operative dates. The change to the New Jobs Tax Credit would result in the credit no longer being operative at the end of the calendar quarter that the Franchise Tax Board (FTB) estimates that the cumulative total of the credits claimed will reach $100 million. The California New Markets Tax Credit Program would be specifically operative for taxable years beginning on or after January 1, 2013, and before January 1, 2020.

| Board Position: | | | Executive Officer | Date |
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**ANALYSIS**

CURRENT FEDERAL/STATE LAW

New Jobs Tax Credit

Federal Law

Existing federal laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) 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. Federal law does not provide a credit comparable to the New Jobs Tax Credit.

State Law

Current state tax law, SBX3 15 (Calderon, Stats. 2009, Third Extraordinary Session, Ch. 17), allows a credit, for taxable years beginning on or after January 1, 2009, to a qualified employer in the amount of $3,000 for each qualified full-time employee hired in the taxable year, determined on an annual full-time equivalent basis. The credit has a cap of $400 million for all taxable years. The FTB calculates the aggregate credit usage and estimates when the cap will be reached, at which point no further credits may be claimed. The credit remains in effect until December 1 of the calendar year after the year in which the cumulative credit limit has been reached and is repealed as of that date. Any credits not used in the taxable year may be carried forward up to eight years.

New Markets Tax Credit

Federal Law

A “new markets tax credit” (NMTC) is allowed for a taxpayer’s qualified equity investments (QEIs) 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 five 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 six 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 plus interest 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.

State 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 has ceased to be operative for taxable years beginning on or after January 1, 2012.

THIS BILL

This bill would reduce the cumulative total amount of credit for all taxable years that can be claimed for the New Jobs Tax Credit from $400 million to $100 million.

For a total of seven taxable years, beginning on or after January 1, 2013, and before January 1, 2020, this bill would allow a QEI credit of 39 percent of the “qualified equity investment” under the Personal Income Tax and Corporation Tax laws.

The aggregate amount of credits for any calendar year that would be allowed is capped at $50 million, in addition to any unused credits carried over from the prior year. The maximum credit allowed would be $350 million for this seven-year credit. The credits would be allocated by the California Tax Credit Allocation Committee (CTCAC).

The bill would define the following terms:

- "Credit allowance date" would mean the date the investment is initially made.
- "Equity investment" would mean any stock, other than nonqualified preferred stock, in a corporation, or any capital interest in a partnership.
- "Low-income community" would mean 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" would mean 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 (40 percent or more) 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" generally would mean 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" would mean any equity investment in a Qualified Community Development Entity (QCDE) if all of the following are met:
  - The investment was acquired for cash at its original issue.
  - 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" would mean 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 that 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.

- "Qualified Community Development Entity" (referred to as QCDE) would mean a domestic corporation or partnership that meets all of the following:
    - Has a primary mission of serving or providing investment capital for low-income communities or persons;
    - Maintains accountability to residents of low-income communities through their representation on a governing board; and
    - Is certified by the CTCAC as being a qualified community development entity.

This bill would provide additional rules that would do all of the following:

- Requires the taxpayer to recapture credits previously utilized to reduce tax if, before the end of the seventh taxable year, 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.
- Disqualifies the business if the corporation repurchases its own stock.
- Allows for the transfer of a qualified equity investment.

This bill would allow an exception to the requirement that 85 percent of gross assets must be invested in a Qualified Low-Income Community Investment for the duration of seven-year credit period: if the investment meets the 85 percent test, even if sold, for a six-year period, then it would be deemed to meet the test for the seventh year. The CDE would not be required to reinvest any capital returned after the sixth year.

This bill does not provide for a carryover of unused credits by the taxpayer.

The CTCAC would develop guidelines that would do the following:

- Create an equitable distribution process for allocation of the credit;
- Set minimum organizational capacity standards;
- Require annual reporting to the CTCAC by each community development organization that receives an allocation; and
- Provide that any unused credits are returned to the CTCAC for subsequent reallocation.

This bill would provide that the guidelines would not be subject to the rulemaking requirements of the Administrative Procedure Act.

The CTCAC would post the information from the annual reporting by the QCDEs and the geographic distribution of credits on its Web site. The CTCAC will impose a reasonable fee upon credit applicants to offset the costs to administer the program.

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 is modeled after the federal New Markets Credit (IRC section 45D). The federal credit is 39 percent spread out over a seven-year period. The credit amount proposed by this bill is also 39 percent of the qualified equity investment; however, the bill is silent concerning spreading the credit over seven years. The bill would make the California credit a one-year credit, not a credit taken over seven years. If it is the author's intention that the credit is taken over seven years, like the federal credit, this bill should be amended.

This bill uses terms that are undefined, e.g., "start-up business" and "real estate project." The absence of definitions to clarify these terms could lead to disputes with taxpayers and would complicate the administration of this credit. The author may wish to amend this bill to clarify these terms.

The bill is silent regarding whether a low-income housing project (a real estate project) that qualifies for this credit would also qualify for the low-income housing credit. If it is the author's intention that only one credit should apply, this bill should be amended.

This bill requires only the credit to be recaptured if a recapture event occurs. The federal new markets credit includes the credit plus interest in the recapture amount when a recapture event occurs. If it is the author's intention that, like the federal recapture rules, interest should also be recaptured, the bill should be amended.

The aggregate amount of the credit that may be "allowed" in any calendar year would be $50 million, plus any unused credits, if any, from the preceding calendar year. The credits allowed would be those credits claimed on an income or franchise tax return. To meet the $50 million "allowed," it could require the CTCAC to "allocate" more than $50 million in credits for the year. If it is the author's intention that the amount of credits "allocated" by the CTCAC would be $50 million, plus any unused credits, the bill should be amended.

## LEGISLATIVE HISTORY

New Jobs Tax Credit

AB 248 (Perea, 2011/2012) would allow an income tax credit for a physician or surgeon who provides non-reimbursed emergency qualified medical services and would reduce the New Jobs Tax Credit allocation from $400 million to $250 million. The bill is currently in the Assembly Appropriations Committee.

AB 304 (Knight, 2011/2012) would allow a credit of $3,000 or $5,000 to an employer with 30 or more employees that moves or establishes a headquarters within California. This bill is currently in the Assembly Revenue and Taxation Committee.

AB 1009 (Wieckowski, 2011/2012) would modify the current New Jobs Tax Credit to increase the allowance of the credit from employers with less than 20 employees to employers with 100 or less employees. This bill is currently in the Revenue and Taxation Committee.

SB 643 (Davis, 2011/2012) would limit the total amount of the New Jobs Tax Credit to $100 million. The "California New Markets" tax credit authorized by the bill would be limited to $300 million. SB 643 is currently in the Assembly for the second reading.

ABX3 15 (Krekorian, Stats. 2010, 3rd Ex. Sess. 2009, Ch. 10) and SBX3 15 (Calderon, Stats. 2010, 3rd Ex. Sess. 2009, Ch. 17) created the New Jobs Tax Credit, which provides a tax credit of $3,000 for each net job increase.

New Markets Tax Credit

SB 1316 (Romero, 2009/2010) would have provided a QEI credit that is the same as the credit provided in this bill. SB 1316 was placed in the Senate inactive file at the request of the author.

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.

<u>New Jobs Tax Credit</u>

*Florida, Illinois, New York, Michigan,* and *Minnesota* do not provide a credit similar to the New Jobs Tax Credit.

*Massachusetts* allows a Full Employment credit to employers who participate in the Full Employment Program and continue to employ a participant for at least one full month. The taxpayer may claim a credit of $100 per month of eligible employment per participant, up to $1,200 per participant.

<u>New Markets Tax Credit</u>

The states surveyed do not allow a credit comparable to the credit proposed by this bill. 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 bill would require a calculation for the New Markets Tax Credit that would require a new form to be developed and would require tracking the credit usage. As a result, this bill would impact the department's printing, processing, and storage costs for tax returns. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

**ECONOMIC IMPACT**

| Estimated Revenue for AB 643 as Amended January 12, 2012<br>For Taxable Years Beginning On or After January 1, 2013 and Before January 1,2020<br>Enactment Assumed After June 30, 2012<br>($ in Millions) | | | |
|---|---|---|---|
| | 2012-13 | 2013-14 | 2014-15 |
| New Markets Tax Credit | -$4.0 | -$59.0 | -$56.0 |
| Change in Jobs Credit from Current Law | $1.3 | $26.0 | $50 |
| Total Revenue Impact | -$2.7 | -$33.0 | -$6.0 |

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

**SUPPORT/OPPOSITION**

Pro: None provided.

Con: None provided.

## ARGUMENTS

Pro: This bill could help stimulate job creation by offering a tax incentive to taxpayers that provide investment for capital or loans to support businesses and initiate projects in low-income areas.

Con: Some taxpayers may say that with the state's current fiscal crisis additional tax expenditures should be avoided.

## LEGAL IMPACT

Federal law prohibits discriminatory state taxation of interest on federal securities. This bill would allow a credit for 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.

## POLICY CONCERNS

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.

## LEGISLATIVE STAFF CONTACT

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