Franchise Tax Board

ANALYSIS OF AMENDED BILL

Authors:	Medina & V. Manuel Pérez	Analyst:	Diane Deatherage	Bill Number:	AB 1399
Related Bills:	See Legislative History	Telephone:	845-4783	Amended Dates:	June 9, 2014, June 18, 2014, & July 3, 2014
		Attorney:	Bruce Langston	Sponsor	

SUBJECT:	California New Markets Tax Credit

SUMMARY

This bill would allow a credit, under the Personal Income Tax Law (PITL) and Corporation Tax Law (CTL), in modified conformity with the federal New Markets Tax Credit (NMTC).

RECOMMENDATION

No position.

Summary of Amendments

The June 9, 2014, June 18, 2014, and July 3, 2014, amendments made numerous technical and substantive changes to the bill. The most substantive amendments (1) extended the operative date of the NMTC to taxable years beginning before January 1, 2027, (2) allowed insurance companies subject to the gross premiums tax to utilize the NMTC, (3) assigned administrative authority for the NMTC to the California Competes Tax Credit Committee (Tax Credit Committee), and (4) specified that the NMTC cannot be sold and is nonrefundable.

As a result of these amendments, several implementation considerations and all technical considerations, as discussed in the department's analysis of the bill as amended September 6, 2013, have been resolved. Additionally, the amendments raised new implementation considerations and technical considerations.

This analysis supersedes the previous analysis for the bill as amended on September 6, 2013.

REASON FOR THE BILL

The reason for this bill is to stimulate stable private sector investment in lower income communities by providing a tax incentive for investing in qualified community development entities.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and operative for taxable years beginning on or after January 1, 2015, and before January 1, 2027.

Board Position:						Executive Officer	Date
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FEDERAL/STATE LAW

The "Federal New Markets Tax Credit" is allowed for a taxpayer's qualified low-income community investments (stock or equity interest) in a qualified community development entity (Development Entity), which must be a corporation or a partnership. The Development Entity'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 New Markets Tax Credit totals 39 percent of the qualified equity investment made in the Development Entity 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 Development Entity can sell qualified equity investments eligible for the federal New Markets Tax Credit, it must apply for and be granted an allocation of the credit from the Community Development Financial Institution Fund (Community Fund), 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.

The credit is determined by applying the above applicable percentage (five or six percent) to the amount paid to the Development Entity for the investment at its original issue, and is available to the taxpayer who holds the qualified equity investment on the date of the initial investment or on the respective anniversary date that occurs during the taxable year.

The credit is recaptured if at any time during the seven-year period that begins on the date of the original issue of the investment the entity: (1) ceases to be a qualified Development Entity; (2) the proceeds of the investment cease to be used as required; or (3) the equity investment is redeemed.

A Development Entity is any domestic corporation or partnership: (1) whose primary mission is serving or providing investment capital for low-income communities or low-income persons; (2) that maintains accountability to residents of low-income communities by their representation on any governing board of or any advisory board to the Development Entity; and (3) that is certified by the Secretary of the Treasury as being a qualified Development Entity.

A qualified low-income community investment means stock (other than nonqualified preferred stock) in a corporation or a capital interest in a partnership that is acquired directly from a Development Entity for cash, and includes an investment of a subsequent purchaser if such investment was a qualified low-income community investment in the hands of the prior holder.

Substantially all of the investment proceeds must be used by the Development Entity to make qualified low-income community investments. For this purpose, qualified low-income community investments include: (1) capital or equity investments in, or loans to, qualified active low-income community businesses; (2) certain financial counseling and other services specified in regulation prescribed by the Secretary to businesses located in and residents of low-income communities; (3) the purchase from another Development Entity of any loan made by such entity that is a qualified low-income community investment; or (4) an equity investment in, or loan to, another Development Entity.

A "low-income community" is a population census tract with either a poverty rate of at least 20 percent or median family income which does not exceed 80 percent of the greater of metropolitan area median family income or statewide median family income (for a non-metropolitan census tract, does not exceed 80 percent of statewide median family income). In the case of a population census tract located within a high migration rural county, low-income is defined by reference to 85 percent (as opposed to 80 percent) of statewide median family income. For this purpose, a high migration rural county is any county that, during the 20-year period ending with the year in which the most recent census was conducted, has a net out-migration of inhabitants from the county of at least 10 percent of the population of the county at the beginning of such period.

The Secretary of the Treasury is required to prescribe regulations designating "targeted populations" as low-income communities for purposes of the New Markets Tax Credit. For this purpose, a "targeted population" is defined by reference to section 103(20) of the Riegle Community Development and Regulatory Improvement Act of 1994 (the "Act") to mean individuals, or an identifiable group of individuals, including an Indian tribe, who are low-income persons or otherwise lack adequate access to loans or equity investments. Section 103(17) of the Act provides that "low-income" means: (1) for a targeted population within a metropolitan area, less than 80 percent of the area median family income; and (2) for a targeted population within a non-metropolitan area, less than the greater of 80 percent of the area median family income, or 80 percent of the statewide non-metropolitan area median family income. A targeted population is not required to be within any census tract. In addition, a population census tract with a population of less than 2,000 is treated as a low-income community for purposes of the credit if such tract is within an empowerment zone, the designation of which is in effect under Internal Revenue Code (IRC) section 1391, and is contiguous to one or more low-income communities.

A qualified active low-income community business is defined as a corporation or partnership that satisfies, with respect to a taxable year, the following requirements: (1) at least 50 percent of the total gross income of the business is derived from the active conduct of a qualified business within any low-income community; (2) a substantial portion of the use of the tangible property of the business is within a low-income community; (3) a substantial portion of the services performed for the business by its employees is performed in a low-income community; and (4) less than five percent of the average of the aggregate unadjusted basis of the property of the business is attributable to certain financial property or to certain collectibles. Sole proprietorships and portions of a business can also be treated as a qualified active low-income community business if certain requirements are met.

A diagram illustrating the relationships between the organizations involved with the New Markets Tax Credit program can be found in Exhibit A, as attached.

Although California does not conform to the federal New Markets Tax Credit, a 20 percent state credit is allowed for each “qualified investment” in a California “community development financial institution” (Institution). Unlike the federal credit, the “qualified investment” in the California Institution must be at least $50,000, for a minimum duration of 60 months, and consist of either of the following:

- A deposit or loan that does not earn interest.
- An equity investment.

California law provides for a recapture of the Institution credit if the “qualified investment” is reduced or withdrawn before the end of the 60-month period. This credit is operative through taxable years beginning before January 1, 2017.

For taxable years beginning on or after July 1, 2008, California allows corporations that are members of the same unitary combined reporting group to assign “eligible” credits to other members of the group. An “eligible” credit is any credit earned by the 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, that was eligible to be carried forward to the first taxable year beginning on or after July 1, 2008. The credit assignment is made by an irrevocable election. The assignor and assignee taxpayers must be members of the same combined reporting for the taxable year in which the credit is earned and the taxable year the credit is assigned.

THIS BILL

For taxable years beginning on or after January 1, 2015, and before January 1, 2027, this bill would, under both the PITL and CTL, allow a cumulative credit, as described below, equal to 39 percent of a taxpayer’s qualified equity investment. The credit would be repealed by its own terms as of December 1, 2028.

The credit would be in conformity with the federal New Markets Tax Credit provisions, with the following modifications:

- Authorize the California Competes Tax Credit Committee (Tax Credit Committee) as the administering agency for the NMTC program.
- Replace references to "Secretary" with "committee".
- Allow a 39 percent credit to be claimed in the following manner:
    - Zero percent for the first two credit allowance dates;
    - Seven percent on the third credit allowance date; and
    - Eight percent on each of the remaining credit allowance dates (fourth through seventh).
- Allow the credit to a taxpayer that holds the qualified equity investment on the credit allowance date and the six subsequent anniversaries of the credit allowance date.
- Specify that the credit cannot be sold and is nonrefundable.

- Require that a qualified community development entity be an entity that has an allocation agreement dated on or after January 2, 2012, with the Community Development Financial Institutions Fund of the U.S. Treasury that includes California within the service area.
- Require the qualified low-income community to be in California.
- Allow employees of a service-based qualified business to perform services outside the low-income community.
- Limit eligibility as a "qualified active low-income community business" to businesses located within census tracts that meet one of the following:
    - Poverty rate is greater than 30 percent;
    - Median family income is equal or less than 60 percent of the California median family income, if located within a non-metropolitan area;
    - Median family income is equal to or less than 60 percent of the greater of the California median family income or metropolitan area median family income, if located within a metropolitan area; or
    - Unemployment rate is at least 1.5 times the national average.
- Provide a rule for determining a low-income community when the U.S. Census Bureau discontinues using the decennial census to report median family income on a census tract basis.
- Allow startup businesses to be considered a qualified active low-income community business for California purposes.
- 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 the 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 qualified community development entity would not be required to reinvest any capital returned after the sixth year.
- Provide that a qualified active low-income community business would include an operating business that, at the time the initial investment is made, has 250 or less employees and is located in a low-income community.
- Provide that the Tax Credit Committee shall recapture the credit claimed on a return when:
    - Any portion of the federal NMTC has been recaptured. In this case, the committee's recapture would be proportionate to the federal recapture with respect to the qualified equity investment.
    - The Development Entity redeems or makes principal repayment with respect to a qualified equity investment prior to the seventh anniversary of the issuance of the qualified equity investment. In this case, the committee's recapture would be proportionate to the amount of the redemption or repayment with respect to the qualified equity investment.
    - The Development Entity fails to (1) invest at least 85 percent of the purchase price of the qualified equity investment in qualified low-income community investments in California within 12 months and (2) maintain at least 85 percent of such level of investment in qualified low-income community investments in California until the last credit allowance date.

- Allow credits in excess of a taxpayer's current year tax liability to be carried forward for seven subsequent years.
- Allow an aggregate annual amount of credits for each calendar year of up to $40 million, in addition to any unused credits allocated from the prior year. The maximum credits allocated over the life of this credit would be capped at $200 million.

An illustration of the relationships that could be established between the organizations involved with the California New Markets Tax Credit program can be found in Exhibit A, attached.

The Tax Credit Committee would be required to establish and impose reasonable fees upon entities that apply for the credit allocation and develop guidelines to adopt an allocation process 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 Tax Credit Committee by each community development organization that receives an allocation; and
- Provide that any unused credits are returned to the Tax Credit Committee for subsequent reallocation.

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

The Tax Credit Committee would be required to post the information from the annual reporting by the qualified development entities and the geographic distribution of credits on its Web site.

Funding for this bill would be provided through the reallocation of previously authorized expenditures from the California State Sales and Use Tax Exclusion Program.[1]

This bill would require the California Alternative Energy and Advanced Transportation Financing Authority to annually determine the difference between the $100 million statutory limitation on the sales and use tax exclusion and the amount assigned during the calendar year. The difference would be made available to the Tax Credit Committee for award to qualified development entities in the following calendar year under the NMTC 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.

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[1] Revenue and Taxation Code section 6010.8.

The Tax Credit Committee would be required to issue specific regulations relating to financial counseling, may certify an entity as being a qualified community development entity, and may designate areas within the census tracts as low-income communities. If the author's intent is to follow existing federal provisions, this bill must be amended.

It is unclear that the Tax Credit Committee would have the information required to be posted on their website. The author may wish to amend this bill to clarify the mechanism for obtaining and posting the specified information.

The recapture modification language is unclear. It is recommended that this bill be amended to clarify the following:

- It is unclear under the recapture rules how the responsibilities are divided between the committee and the Franchise Tax Board (FTB). For example, the language states that the committee shall recapture the tax credit allowed from the entity that claimed the credit, but the FTB is in the position to recapture a tax credit from an entity that claimed a tax credit. As another example, it is unclear who would be responsible for monitoring the six-month cure period prior to recapture. It is also unclear how the proportionate recapture of the credit would be calculated.
- The bill fails to specify when a recapture would be triggered and reported.
- Any recaptured credits must be returned to the committee by March 1 of the year following the recapture and allocated in the following calendar years as described. It is unclear whether recaptured credits would affect the $40 million annual limit or the $200 million cumulative limit.

This bill uses undefined phrases, "duration of the investment" and "qualified community and economic development entities." The absence of definitions to clarity these phrases could lead to disputes with taxpayers and would complicate the administration of this credit.

The intent of the modification of Internal IRC section 45D(d)(1)(A) is unclear and appears to be unnecessary as the modification duplicates existing federal language and can be deleted.

The bill specifies that unused credits shall be returned to the committee on a specified date, March 1 of the year following allocation. If this is contrary to the author’s intent, this bill should be amended.

TECHNICAL CONSIDERATIONS

A credit allowed or allocated to a partnership, limited liability company, or "S" corporation may be allocated to the partners, members, managers, or shareholders in accordance with the agreement among such partners, members, managers, or shareholders. It is unclear if the author's intent is to turn off the federal law[2] that disregards allocation of partnerships that lack substantial economic effect. The author may wish to amend the bill to clarify the intent.

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[2] Internal Revenue Code section 704(b).

"Relating to" phrases should reflect the IRC titles. In this bill, several "relating to" phrases are inaccurate. The IRC title should be used verbatim where there is a title. When there is no title or the title is "General", a "relating to" phrase would be an inaccurate reference to the IRC. The bill should be amended to reflect accurate references to the IRC.

The amendments to Revenue and Taxation Code (R&TC) section 18410.2 inadvertently applies the recapture rules for the California Competes Tax Credit to the NMTC that this bill would create and unnecessarily duplicates language contained elsewhere in the bill. The amendments to R&TC section 18410.2 should be eliminated.

The recapture language contains technical errors. For example, the committee would recapture the credit, when the Development Entity redeems or makes principal repayment with respect to a qualified equity investment prior to the seventh anniversary of the issuance of the qualified equity investment. It is inaccurate to state that a Development Entity would make principal repayment with respect to a qualified equity investment. The author may wish to amend the bill for clarity.

The bill language with respect to the credit for insurers subject to the gross premiums tax inadvertently allows the FTB to prescribe rules and regulations for provisions of the R&TC administered by a different agency. The bill should be amended to eliminate the insurance taxation provisions from the FTB's authority to make rules and regulations.

Subdivision (c) in each R&TC section needs to be amended where the term "Low-Income Tax Credit Program" appears, as it should be "Low-Income Housing Tax Credit Program" to reference the correct program.

LEGISLATIVE HISTORY

AB 305 (V. Manuel Pérez, et al., 2013/2014) would have reduced the total amount of the New Jobs Tax Credit and created a new California New Markets Tax Credit Program for taxable years beginning on or after January 1, 2013, and before January 1, 2020. The program would have been administered by the California Tax Credit Allocation Committee with $40 million in credits available for allocation each year. AB 305 failed to pass out of the Assembly Appropriations Committee by the constitutional deadline.

AB 643 (Davis and V. Manuel Pérez, 2011/2012) would have, among other things, established a New Markets Tax Credit program for taxable years beginning on or after January 1, 2013, and before January 1, 2020. The program would have been administered by the California Tax Credit Allocation Committee with $50 million in credits available for allocation each year. AB 643 failed to pass out of the Assembly Appropriations Committee by the constitutional deadline.

AB 2037 (Davis, V. Manuel Pérez, et al., 2011/2012) a similar bill, would have established a New Markets Credit program for taxable years beginning on or after January 1, 2013, and before January 1, 2020. The credits allowed would have been $50 million per year. The program would have been administered by the California Tax Credit Allocation Committee. AB 2037 failed to pass out of the Assembly by the constitutional deadline.

OTHER STATES' INFORMATION

Florida and *Illinois* have a New Markets Tax Credit Program similar to the one proposed by this bill. The computation of the credit in each state is based on the federal New Markets Tax Credit with some modifications. The credit percentages are the same as proposed in this bill and both states offer a five year carryover of unused credits. *Illinois* charges a $5,000 non-refundable application fee to participate in the program.

Although *New York, Michigan,* and *Minnesota* do not allow a credit comparable to the credit proposed by this bill, these 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

Implementing this provision would result in costs of approximately $131,000 for fiscal year 2015/16 for information technology system programming changes and additional personnel hours, and $13,000 in annual on-going costs.

ECONOMIC IMPACT

Estimated Revenue Impact of AB 1399 As Amended July 3, 2014 Assumed Enactment By September 30, 2014 ($ in Millions)			
2015-16	2016-17	2017-18	2018-19
$0.0	- $1.5	- $5.4	- $10

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

LEGAL IMPACT

This bill would restrict the NMTC to investments in California. This bill could raise constitutional concerns under the Commerce Clause of the United States Constitution because it could appear to improperly favor in-state activity over out-of-state activity. On August 28, 2012, (*Cutler* v. Franchise Tax Board), the Court of Appeal issued a unanimous opinion holding that California's Qualified Small Business Stock statutes were unconstitutional. Specifically, the Court of Appeal held that the statutory scheme's requirement of a large California presence in order to qualify for an investment incentive discriminated against interstate commerce, and therefore violated the federal dormant commerce clause. While no court decision has yet invalidated, as a general matter, state income tax credits that provide an incentive for in-state activity, i.e., property placed in service in the state, employees employed in the state, etc., targeted tax credits such as the NMTC in California may be subject to constitutional challenge.

Federal law allows states to impose a non-discriminatory franchise tax 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. The credit provides an indirect subsidy by encouraging these loans over investments in federal securities and providing more favorable tax benefits for making the loan instead of holding federal securities. As a result, this tax benefit could be considered to result in discrimination against investments in federal securities and thus a violation of the federal prohibition of discriminatory state taxation of federal securities.

SUPPORT/OPPOSITION[3]

Support: Advantage Capital Partners; Association of California Life and Health Insurance Companies; California Urban Partnership; League of California Cities.

Opposition: None provided.

ARGUMENTS

Proponents: Supporters could argue that this bill could help stimulate economic development by offering a tax incentive to taxpayers that provide investment for capital or loans to support businesses and initiate projects in low-income areas.

Opponents: Some may argue that income tax credits may be an inefficient way to encourage economic development because economic investment decision-making is often separate from tax planning decision-making.

POLICY CONCERNS

This bill would allow a taxpayer to obtain combined federal and state credits equal to 74 percent of the investment even in cases where the federal credit alone would make the Development Entity's low-income community investment economically feasible. Consequently, the author may wish to provide that a specified degree of economic necessity is present before the Development Entity may market the state credit.

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[3] From the Senate Governance and Finance Committee analysis, dated June 24, 2014.

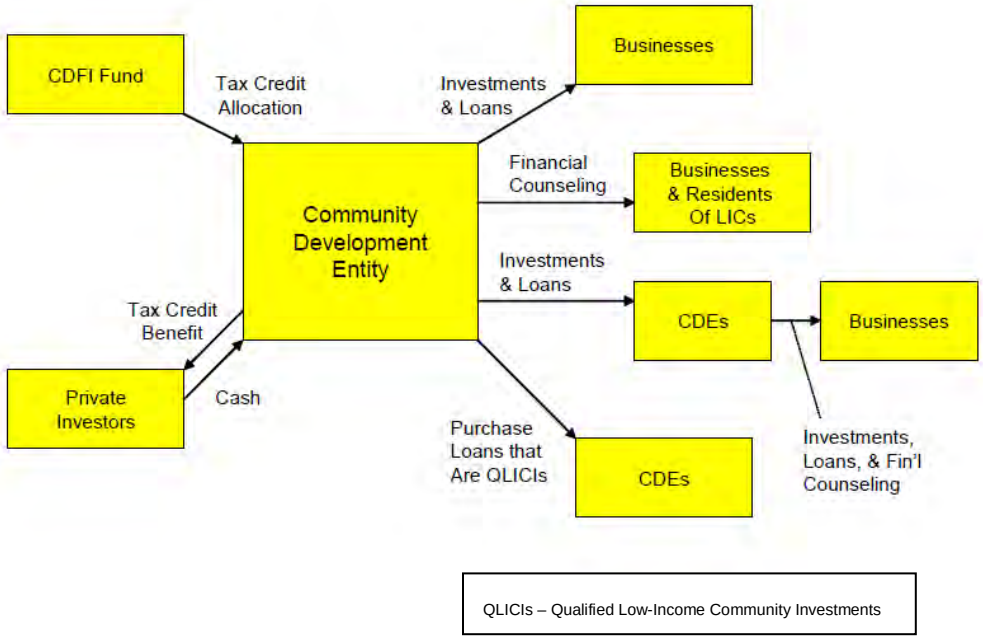
Exhibit A

Example of Interaction of the Federal New Markets Tax Credit

The following diagram demonstrates the relationship between the organizations involved with the federal New Markets Tax Credit program.

In the upper left hand corner is the Community Development Financial Institution Fund (CDFI Fund), which has authority to allocate a portion of the federal New Markets Tax Credit limitation to the Community Development Entity (CDE), which means that the CDFI Fund allocates equity eligible for the credit.

Private investors (lower left hand corner) make cash investments in the CDE and claim the credit on their federal income tax returns. Although not demonstrated here, the investor may leverage the investment by investing funds borrowed from another source, thereby increasing the amount of the investment and credit.

The CDE must then invest substantially all of the cash in low-income communities (LICs) within 12 months of receiving the funds.

On the right-hand side of the chart are the types of investments the CDE can make.