ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author:	Medina & V. Manuel Pérez	Analyst:	Diane Deatherage	Bill Number:	AB 1399
Related Bills:	See Legislative History	Telephone:	845-4783	Amended Date:	September 6, 2013
		Attorney:	Bruce Langston	Sponsor:	

SUBJECT: California New Markets Tax Credit Program

SUMMARY

This bill would allow a credit, under 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 September 6, 2013, amendments removed provisions of the bill related to economic development, and replaced them with the provisions discussed in this analysis. This is the department's first analysis of the bill. This analysis only addresses the provisions of this bill that impact the department's programs and operations.

REASON FOR THE BILL

The reason for this bill is to stimulate economic development, and hasten California's economic recovery, by authorizing 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 specifically operative for taxable years beginning on or after January 1, 2015, and before January 1, 2021.

ANALYSIS

FEDERAL 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

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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 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.

STATE LAW

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, 2021, this bill would, under both the PITL and CTL, allow a credit equal to 39 percent[1] of a taxpayer's "qualified equity investment." The repeal date would be December 1, 2028.

The credit would be allowed only if the taxpayer holds the qualified equity investment on the credit allowance date and the six subsequent anniversaries of the credit allowance date.

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

- The credit would be allocated by the California Tax Credit Allocation Committee (Credit Allocation Committee). The Committee would be responsible for the administration of this credit program and "Committee" is substituted for "Secretary" every place it appears.
- 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).
- Provide that any allocation not used within the three year period may be allocated by the Credit Allocation Committee.
- Require the qualified low-income community to be in California.
- 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.
- Include in the low-income community investment any capital or equity investment in, or loan to, any real estate project or 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.
- Allow startup businesses to be considered a qualified active low-income community business for California purposes.

[1] Zero percent for years one and two, plus, seven percent for year three, plus, eight percent for years four through seven equals 39 percent.

- 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 qualified Development Entity would not be required to reinvest any capital returned after the sixth year.
- Remove the requirement for a qualified active low-income community business that a substantial portion of the services performed for business entity by its employees are performed in any low-income community.
- In lieu of the provisions of federal law allowing portions of a business to be a qualified active low-income community business, 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.
- Modify the definition of recapture event to provide a recapture event would not have occurred and an investment would be considered held by a qualified community development entity upon its sale or repayment, provided the qualified community development entity reinvests an amount equal to the capital returned to or recovered by the qualified community development entity from the original investment, exclusive of any profits realized, in another qualified low-income community investment within 12 months of the receipt of that capital. A qualified community development entity would not be required to reinvest capital returned from a qualified low-income community investment after the sixth anniversary of the issuance of the qualified equity investment, the proceeds of which were used to make the qualified low-income community investment. The qualified low-income community investment would be considered held by the qualified community development entity through the seventh anniversary of the issuance of the qualified equity investment.

Credits in excess of a taxpayer's current year tax liability may be carried forward for eight subsequent years.

The aggregate annual amount of credits allowed for each calendar year would be capped at $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.

Because the credit computation for the California New Markets Tax Credit is based on IRC section 45D, as described above, an example illustrating the relationships that could be established between the organizations involved with the California New Markets Tax Credit program can be found in Exhibit A, as attached.

The Credit Allocation Committee would establish and impose reasonable fees upon entities that apply for the credit allocation. Also, the Credit Allocation Committee would 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 Credit Allocation Committee by each community development organization that receives an allocation; and
- Provide that any unused credits are returned to the Credit Allocation 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 Credit Allocation Committee would 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.[2]

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 sales and use tax exclusion and the amount assigned during the calendar year. The difference is made available to the Credit Allocation Committee for award to qualified Development Entities in the following calendar year under the New Markets Tax Credit 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.

The bill would modify the references to "the Secretary" to read "the committee". This substitution would require the committee to issue specific regulations to describe what constitutes financial counsel and under which one or more targeted populations will be treated as low-income communities. Because the bill lacks language on how these two provisions would be modified, it may be an unintended consequence of the substitution language where California would rather follow the federal regulations on those two provisions. If contrary to the author's intent, this bill should be amended.

The bill would modify the rules for recapture of the credit for circumstances that do not appear to provide the basis for recapture under federal law. As result, the necessity and purpose of these modifications are unclear.

The Credit Allocation Committee would be responsible for the administration of the New Markets Tax Credit program. However, the credits allowed would be those credits claimed on a California income or franchise tax return to reduce the income or franchise tax of a taxpayer. The Franchise Tax Board (FTB) would be the agency that would most easily monitor the amount of credits "allowed" and the amount credits recaptured. It is unclear if the FTB would have to report the amount of credits claimed on income and franchise tax returns to the Credit Allocation Committee in order to cut off the allowed credits at the maximum, or would the FTB be responsible for cutting off the credits when the reported credits reach the $40 million maximum for the calendar year?

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[2] Revenue and Taxation Code Section 6010.8.

The federal recapture law specifies three events that would be a recapture event with respect to an equity investment in a qualified community development entity: (1) the entity ceases to be a qualified community development entity, (2) the proceeds of the investment cease to be used as required, (3) such investment is redeemed by the entity. The modification to the federal recapture rules would add an exception to the federal recapture rules, however the modification language is unclear and contains technical errors. The author may wish to amend the recapture provisions in the bill.

The bill lacks a provision for the FTB to formulate rules and regulations for the New Markets Tax Credit. The author may wish to add language that would allow the FTB to issue any appropriate regulations necessary to carry out the provisions in this bill.

TECHNICAL CONSIDERATIONS

This bill would allow a tax credit for taxable years beginning on or after January 1, 2015, and before January 1, 2021 (six taxable years). The credit amount would be determined by taking the specified percentage of the investment on the credit allowance dates over a seven-year period. As written, a taxpayer that invests in taxable year 2020 would be unable to take advantage of the credit as the first year's percentage is zero and subsequent credit allowance dates would be after the bill is repealed and therefore ineligible. If it is the author's intention to cover investments made during taxable years beginning on or after January 1, 2015 and before January 1, 2021, the bill's operative date language should be amended to reflect that the credit would be allowed for investments made during that timeframe.

On page 4, line 25, modification language that is to be replaced in IRC section 45D is incorrect. The existing language should be shown as "any low-income community" as opposed to "qualified low-income community investments" as written in the bill.

IRC section 45D(g)(2)(B) provides that recapture of the credit is subject to interest under IRC section 6621. The bill should modify this language for California to substitute "section 6621" with "section 19101 of the Revenue and Taxation Code" in R&TC sections 17053.9 and 23622.9.

Incorrect references to national limitation on the amount of investments designated need to be amended. On page 5, line 4, "45(D)(f)(1)" should be stricken. On page 9, line 9, "45(D)(f)(1)" should be stricken and replaced with "45D(f)(1)."

On page 5, line 26, modification language for IRC section 45D(g)(3) should be revised to insert "qualified" before "community development entity."

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

Department staff is unable to determine the costs to administer this bill until the implementation concerns have been resolved, but anticipate the costs to be significant.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of AB 1399 As Amended September 6, 2013 Assumed Enactment After June 30, 2014 ($ in Millions)			
2014-15 through 2015-16	2016-17	2017-18	2018-19
$0.0	- $2.3	- $8.4	- $16

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 tax credit 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 New Markets Tax Credit in California may be subject to constitutional challenge.

Federal law allows states to impose a non-discriminatory franchise tax on national banks. 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 national banks.

SUPPORT/OPPOSITION

Support: None provided.

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.

LEGISLATIVE STAFF CONTACT

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Exhibit A

Example of Interaction of the Federal New Markets Tax Credit

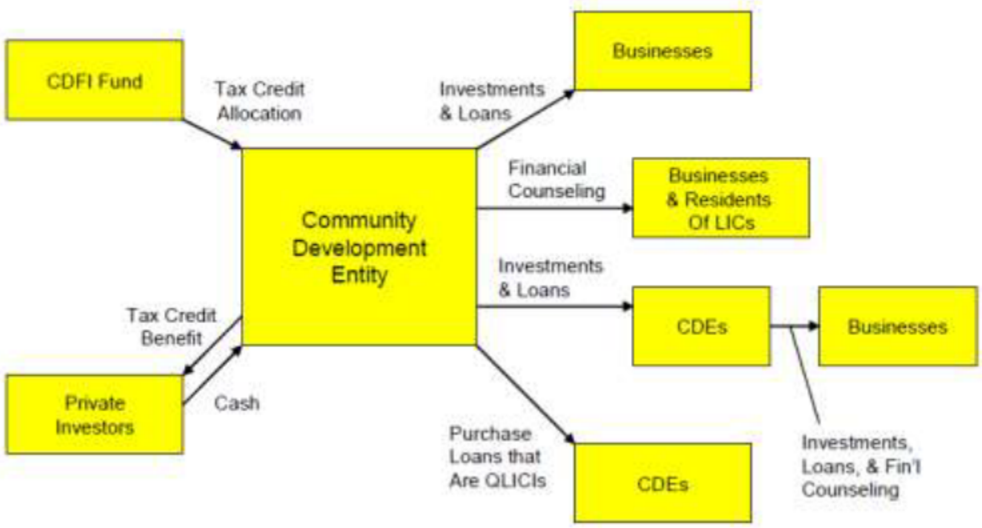
The following diagram demonstrates the relationship between the organizations involved with the federal New Markets Tax Credit program.

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.



QLICIs – Qualified Low-Income Community Investments