

# ANALYSIS OF AMENDED BILL

## Franchise Tax Board

Author: Perez, et al. Analyst: David Scott Bill Number: AB 305  
Related Bills: See Legislative History Telephone: 845-5806 Introduced and Amended Dates: February 12, 2013 and April 16, 2013  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** 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
- Create a new tax credit for investments in businesses that provide capital or loans to low-income communities (California New Markets Tax Credit Program).

### RECOMMENDATION

No position.

### Summary of Amendments

The bill as introduced on February 12, 2013, would amend the New Jobs Tax Credit and add the California New Markets Tax Credit Program discussed in this analysis.

The April 16, 2013, amendments added co-authors, modified the aggregate limit on the New Jobs Tax Credit, and made several substantive changes to the provisions creating the California New Markets Tax Credit Program.

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

### REASON FOR THE BILL

The reason for 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 becoming inoperative at the end of the calendar quarter in which the Franchise Tax Board (FTB) estimates that the cumulative total of the credits claimed would reach \$200 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.

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## **ANALYSIS**

### **New Jobs Tax Credit<sup>1</sup>**

#### 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 has no credit comparable to the New Jobs Tax Credit.

#### State Law

Current state tax law allows a New Jobs Tax Credit 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 is responsible for determining the cut-off date (the last day of the quarter in which the \$400 million cap will be reached), after which claims for the credit will no longer be allowed. 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 “Federal New Markets Tax Credit” is allowed for a taxpayer’s qualified equity investments to acquire stock or equity interest in a 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.

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<sup>1</sup> Although the New Jobs Tax Credit is referred to as the “Small Business Hiring Credit” in the California Income Tax Expenditures report for December 2011 <[https://www.ftb.ca.gov/aboutftb/Tax\\_Expenditure\\_Report\\_2011.pdf](https://www.ftb.ca.gov/aboutftb/Tax_Expenditure_Report_2011.pdf)>, the name in common use on the department’s forms, instructions, and website is used in this analysis.

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 qualified 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 equity 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 equity 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 to businesses and residents in 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 authorized to designate "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 business 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 trade or business activities in any low-income community; (2) a substantial portion of the tangible property of the business is used in 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.

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

The maximum annual amount of qualified equity investments was \$3.5 billion for calendar years 2010 through 2013.<sup>2</sup>

### State Law

Although California does not conform to the Federal New Markets Tax Credit, a 20 percent state credit was 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 have been at least \$50,000, for a minimum duration of 60 months, and consisted 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 inoperative for taxable years beginning on or after January 1, 2012.

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<sup>2</sup> Section 305 of P.L. 112-240, American Taxpayer Relief Act of 2012.

California allows members of the same unitary group to assign “eligible” credits to other members of the group. An “eligible” credit is any credit, including the Institution 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.

### THIS BILL

This bill would reduce the cumulative total amount of credit that can be claimed for the New Jobs Tax Credit from \$400 million to \$200 million.

For a total of seven taxable years, beginning on or after January 1, 2013, and before January 1, 2020, this bill would, under both the Personal Income Tax Law and Corporation Tax Law, allow a California Qualified Equity Investment Credit equal to 39 percent of a taxpayer’s “qualified equity investment.”

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 amount would be computed in accordance with the Federal New Markets Tax Credit provisions, with the following modifications:

- The credits would be allocated by the California Tax Credit Allocation Committee (Credit Allocation Committee).
- Allows the 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 (four through seven).
- Reduces the period for using the credit before the credit could be reallocated by the Credit Allocation Committee, from five years (for the federal credit) to one year (for the California credit).
- Requires the qualified low-income community to be in California.
- Low-income community investment includes 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.
- Excludes services of the taxpayer performed at the low-income community as a qualified active low-income community business.
- Allows startup businesses as a qualified active low-income community business for California purposes.

- Allows 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.

The aggregate annual amount of credits allowed for each calendar year from 2013 to 2020, inclusive, would be capped at \$40 million, in addition to any unused credits allocated from the prior year. The maximum credits allowed over the life of this credit would be capped at \$200 million.

Credits in excess of a taxpayer's current year tax liability would be ineligible for carry forward to subsequent years.

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.

#### 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 terms that are undefined, e.g., "real estate project" and "time of initial investment." 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 for clarity.
- The bill requires that if an investment is made in an operating business, the business must have 250 or less employees. The language is silent as to the timing and method of determining the number of employees, (e.g., Head count at year end? Full-time equivalents?). The author may wish to amend the bill to clarify this issue.
- The California New Markets Tax Credit section would be in effect only until December 1, 2020, and would be repealed as of that date. The result would be that the credit could not be taken after that date. Investors making an investment might be barred from utilizing the full amount of their credit. For example, an investor making a qualified investment in 2018 would have zero credit allowable for the first two years because the allowed percentage is zero for the first two years. The credit would repeal as of December 1, 2020, and with the investor filing their return in 2021 for the 2020 taxable year no credit would be allowed because of the repeal of this section. If this is contrary to the author's intent, the author may wish to amend the bill.

## TECHNICAL CONSIDERATIONS

On page 3, line 20, the subdivision reference number is a capital “I,” which should be a lower case “i”.

On page 8, line 23, and on page 12, line 37, “community” should be inserted after “low-income”.

On page 9, line 18, and on page 13, line 33, strikeout “allowed” and insert “allocated”.

On pages 8 and 13, the language defines “substantial portion” as 40 percent or more. The language duplicates the federal guidelines and locks into a state only rate. If federal guidelines change, the state definition would not. The author may wish to make the following technical corrections:

On page 8, line 34, strikeout ““Substantial portion” shall be defined as 40 percent or” and strikeout lines 35 and 36.

On page 13, line 9, strikeout ““Substantial portion” shall be defined as 40 percent or” and strikeout lines 10 and 11.

If the author does not wish to make the above corrections, then the following corrections would need to be made:

On page 8, line 35, after “more of”, insert “the use of” and on page 13, line 10, after “more of”, insert “the use of”.

## **LEGISLATIVE HISTORY**

### New Jobs Tax Credit

AB 234 (Wieckowski, 2011/2012) would have modified the New Jobs Credit by limiting the credit to employers who hire any employee that was unemployed for at least the 30 days prior to being hired. This bill failed to pass out of the Assembly Revenue and Taxation Committee by the constitutional deadline.

AB 246 (Wieckowski, 2011/2012) would have modified the New Jobs Credit by increasing the amount per employee and changing the definition of qualified employer. This bill failed to pass out of the Senate by the constitutional deadline.

AB 248 (Perea, 2011/2012) would have allowed an income tax credit for a physician or surgeon who provides non-reimbursed emergency qualified medical services and would have reduced the New Jobs Tax Credit allocation from \$400 million to \$250 million. This bill failed to pass out of the Assembly by the constitutional deadline.

AB 304 (Knight, 2011/2012) would have allowed a credit to an employer with 30 or more employees that moves or establishes a headquarters within California. This bill failed to pass out of the Assembly by the constitutional deadline.

AB 643 (Davis and Perez, 2011/2012), a similar bill, would have, among other things, reduced the total amount available for the New Jobs Tax Credit from \$400 million to \$100 million. AB 643 failed to pass out of the Assembly Appropriations Committee by the constitutional deadline.

AB 1009 (Wieckowski, 2011/2012) would have modified the current New Jobs Tax Credit to expand eligibility for the credit from employers with less than 20 employees to employers with 100 or less employees. This bill failed to pass out of the Assembly by the constitutional deadline.

AB 1195 (Allen, 2011/2012) would have modified the New Jobs Credit to expand the credit to employers with 40 or fewer employees. This bill failed to pass out of the Senate by the constitutional deadline.

AB 2037 (Davis, Perez, et, al., 2011/2012) a similar bill, would have reduced the total amount available for the New Jobs Tax Credit from \$400 million to \$100 million. AB 643 failed to pass out of the Assembly by the constitutional deadline.

SB 156 (Emmerson and Cook, 2011/2012) would have modified the New Jobs Credit to allow the credit to employers with 50 or less employees. This bill failed to pass out of the Senate by the constitutional deadline.

ABX3 15 (Krekorian, Chapter 10, Statutes of 2010) and SBX3 15 (Calderon, Chapter 17, Statutes of 2010) created the New Jobs Tax Credit, which provides a tax credit of \$3,000 for each net job increase.

AB 1973 (Swanson, 2009/2010) would have extended the New Jobs Credit to employers hiring ex-offenders. This bill failed to pass out of the Senate by the constitutional deadline.

#### California New Markets Tax Credit

AB 643 (Davis and Perez, 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, Perez, 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.

SB 1316 (Romero, 2009/2010) would have provided a Qualified Equity Investment credit identical to the credit 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 Qualified Equity Investment credit identical to the credit in this bill. AB 251 failed to pass out of the Assembly Rules Committee by the constitutional deadline.

AB 957 (Haynes, 2005/2006) would have provided a Qualified Equity Investment credit identical to the credit provided in this bill. AB 957 failed to pass out of the Assembly Revenue and Taxation 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.

### New Jobs Tax Credit

*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.

### New Markets Tax Credit

*Florida* has a New Markets Tax Credit similar to the one proposed by this legislation. The computation of the credit is based on the federal New Markets Tax Credit with some modifications. The credit percentages are the same as proposed in this legislation and it offers a five year carryover of unused credits.

*Illinois* had a New Markets Development Program which offered a credit similar to the one proposed by this legislation. The credit was computed based on the federal New Markets Tax Credit with some modifications. The credit percentages were the same as this legislation. There was a \$5,000 non-refundable application fee. The *Illinois* credit sunset on December 31, 2012.

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**

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

### Revenue Estimate

Estimated Revenue Impact of AB 305 As Amended April 16, 2013 For Taxable Years Beginning On or After January 1, 2013 Enactment Assumed After June 30, 2013 (\$ in Millions)					
	2013-14	2014-15	2015-16	2016-17	2017-18
New Markets Tax Credit	\$0.0	\$0.0	-\$6.5	-\$6.6	-\$17.0
Change in NJTC <sup>3</sup> from Current Law	+\$42.0	+\$31.0	+\$19.0	+\$13.0	+\$9.2
Total Revenue Impact	+\$42.0	+\$31.0	+\$12.5	+\$6.4	-\$7.8

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

## SUPPORT/OPPOSITION

Support: The East Los Angeles Community Union (TELACU) (Sponsor)  
California League of Cities

Opposition: None provided.

## ARGUMENTS

Proponents: Supporters could argue that 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.

Opponents: Some may argue that, given the state's fragile economic recovery, additional tax expenditures should be avoided.

## LEGISLATIVE STAFF CONTACT

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<sup>3</sup> New Jobs Tax Credit

## 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), 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 within 12 months of receiving the funds.

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

