

# ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: Cedillo Analyst: Jeani Brent Bill Number: AB 601

Related Bills: AB 2458 (1998) Telephone: 845-3410 Introduced Date: 02/19/1999

Attorney: Doug Bramhall Sponsor: \_\_\_\_\_

**SUBJECT:** Urban Incentive Zones/Qualified Adaptive Reuse Buildings Credit

## SUMMARY

Under the Government Code, this bill would authorize a new type of economic development area, called urban incentive zones (UIZ). The Trade and Commerce Agency (TCA) would be required to designate an unspecified number of UIZs from applications submitted by local governing bodies. The designations would be binding in perpetuity.

Local legislative bodies may by ordinance designate buildings located within the UIZ as "qualified adaptive reuse buildings." To be designated, buildings must have been built before 1975 and have been or are likely to be vacant for a period of six months or longer. Qualified adaptive reuse buildings would be eligible for various regulatory, tax, program, and other incentives.

Under the Bank and Corporation Tax Law (B&CTL) and the Personal Income Tax Law (PITL), this bill would allow a tax credit in an amount equal to either of the following:

1. 20% of the amount paid or incurred during the taxable or income year for qualified adaptive reuse, or
2. 30% of the amount paid or incurred during the taxable year for qualified adaptive reuse that includes an affordable housing component or involves the rehabilitation of a building that is listed in the California Register of Historical Resources.

This bill would make various changes to other provisions of the Government Code, the Revenue and Taxation Code, the Health and Safety Code, and the Public Resources Code. These changes do not impact the department's programs or procedures and are not discussed in this analysis.

## EFFECTIVE DATE

As an urgency statute, this bill would become effective immediately upon enactment. However, the bill specifies that the tax credits would apply for taxable or income years beginning on or after January 1, 2000.

## SPECIFIC FINDINGS

**Under the Government Code, existing state law** provides for the designation of enterprise zones, Local Agency Military Base Recovery Areas (LAMBRA), a Targeted Tax Area (TTA), and two Manufacturing Enhancement Areas (MEA). Using specified

Board Position:

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Department Director

Date

**Gerald Goldberg**

**4/16/1999**

criteria, the TCA designates these economic development areas from the applications received from the local governing bodies. Enterprise zones are designated for 15 years (except enterprise zones meeting certain criteria may be extended to 20 years), and TCA has designated the 39 enterprise zones authorized under existing law. When an enterprise zone expires, TCA is authorized to redesignate that zone or designate another in its place to maintain a total of 39 enterprise zones. Eight LAMBRA designations are authorized, at least one from each of the five regions (as specified) of the state. Currently, TCA has designated three of the eight LAMBRAs and two other areas have received conditional designation. Each LAMBRA designation is binding for eight years. The TTA was designated November 1, 1998, and the MEAs were designated October 1, 1998. Both the TTA and MEAs are binding for 15 years beginning January 1, 1998.

**Under the Revenue and Taxation Code, existing state law** provides special tax incentives for taxpayers conducting business activities within economic development areas. These incentives include a sales or use tax credit, hiring credit, business expense deduction, and special net operating loss treatment. Two additional incentives include net interest deduction for businesses that make loans to businesses within the enterprise zones and a tax credit for employees working in an enterprise zone. See attachment A for a more detailed discussion of each of these incentives.

**AB 601, under the Government Code,** would authorize a new type of economic development area, called urban incentive zones (UIZ). TCA would be required to designate an unspecified number of UIZs from applications submitted by local governing bodies with "eligible areas," which is an undefined term. The applications must include definitive boundaries for the proposed UIZ based on an undefined threshold percentage of a concentration of underused or vacant buildings or an undefined overall vacancy factor. The designations would be binding in perpetuity.

From the submitted applications, TCA would be required to select for designation those areas that propose the most effective, innovative, and comprehensive regulatory, tax, program, and other incentives in attracting private sector investment in the UIZ. In designating UIZs, the TCA must consider the location of other economic development areas (including previously designated UIZs) and avoid locating new UIZs in a manner that would adversely affect existing economic development areas. In addition, TCA would be required to include in its designation criteria the fact that certain jurisdictions were declared disaster areas by the President of the United States. This criteria would not include those jurisdictions that received only Gubernatorial disaster area declaration.

Local legislative bodies may by ordinance designate buildings located within the UIZ as "qualified adaptive reuse buildings." In addition to being designated, buildings must have been built before 1975 and have been or are likely to be vacant for a period of six months or longer. The ordinance must require the building owner sign an adaptive reuse restriction agreement that requires the continued use of the property for adaptive reuse housing for a period of five years. This adaptive reuse restriction agreement could be renewed at the option of the building owner for up to an additional 10 years, provided the adaptive reuse housing remains.

Qualified adaptive reuse would include (but is not limited to):

1. conversion of a nonresidential building to include at least 25% of the floor area as residential units or 50% of the floor area as live-work units, or
2. a 50% increase in residential or live-work use of floor area of an existing residential or live-work building.

The term "live-work" building or unit is not defined in the bill or elsewhere in the Government Code.

**Under the B&CTL and the PITL, this bill** would allow a tax credit in an amount equal to either of the following:

3. 20% of the amount paid or incurred during the taxable or income year for qualified adaptive reuse, or
4. 30% of the amount paid or incurred during the taxable year for qualified adaptive reuse that includes an affordable housing component or involves the rehabilitation of a building that is listed in the California Register of Historical Resources.

Under the Revenue and Taxation Code provisions, "qualified adaptive reuse" would have the meaning provided in the Government Code, as discussed above.

"Affordable housing component" is not defined in the bill.

Further, "qualified expenditure" is defined as an expenditure that exceeds 10% of the adjusted basis in the adaptive reuse building. Qualified expenditures must be capitalized and cost recovered with a cost recovery period at least as long as the recovery period of the building.

Any excess credit would be allowed to be carried over indefinitely.

Since **this bill** does not specify, the general rules in state law regarding credits, including division of the credit among taxpayers who share in the costs, would apply.

This credit would not be allowed to reduce regular tax below tentative minimum tax for purposes of alternative minimum tax.

#### Policy Considerations

The department is working with the author's office to resolve the following policy concerns:

1. The bill states that to qualify as adaptive reuse, a building must have been or is likely to be vacant for at least six months. However, the bill does not specify that the vacancy period must occur in proximity with designation as a qualified adaptive reuse building. Thus, a building that experienced seven months of vacancy more than 10 years ago could qualify for designation.

2. This bill would require a property owner to sign an agreement for the continued use of the property for adaptive reuse housing for five years. However, the bill would not require property owners who fail to continue that use of the property to recapture any credit that the owner may already have received.
3. The tax credit provision does not contain a sunset date. Sunset dates generally are provided to allow periodic review by the Legislature.

#### Implementation Considerations

The department is working with the author's office to resolve the following implementation concerns:

1. The credit provisions state that the credit would be allowed for "qualified adaptive reuse," but do not specifically require that the building involved necessarily be one for which an agreement has been executed as provided under the Government Code provisions of the bill.
2. This bill does not specify for which taxpayer (i.e., building owner, lessor, contractor that does the work) the credit would be intended. If the bill does not specify, the potential would exist for multiple credits.
3. This bill does not clearly define which expenditures would qualify as "qualified adaptive reuse." The Government Code provisions of the bill would include in that term any and all costs directly or remotely involved in:
  - A. conversion of a nonresidential building to include 25% of the floor space as residential units or 50% of the floor space as "live-work" units, or
  - B. a 50% increase in residential or "live-work" use of floor area of an existing residential or "live-work" building.
4. This bill does not define the terms "live-work" and "affordable housing component." The lack of definition could lead to disputes between taxpayers and the department regarding the correct interpretation of these terms.
5. Generally, credits that require qualified use of an asset or that require initial validation of the qualified use of the asset also require that the qualification or validation be made by a state agency familiar with the qualification criteria. Without validation by the appropriate state agency, the department would have difficulty administering the credit because the validation function, in this case the qualified use of buildings, is beyond the department's administrative duties and expertise.
6. This bill defines "qualified expenditure," but that term is not tied to the amount paid or incurred for which a credit would be allowed. Further, the paragraph that defines "qualified expenditure" appears to suggest that taxpayers might be allowed some sort of special expense deduction or depreciation deduction. However, the language is too ambiguous to determine its intended application.

7. If this bill is amended to provide a sunset date, the bill also should be amended to limit the number of years the unused portion of credit could be carried forward. Credits with unlimited carryovers must be maintained on tax forms and systems even when the credit has expired. Since tax credits are usually used within eight years, most recently enacted credits contain limited carryover provisions.

#### Technical Considerations

The B&CTL uses the term "taxable year." This term should be changed to "income year."

#### FISCAL IMPACT

##### Departmental Costs

If the bill is amended to resolve the implementation considerations, the department's costs are expected to be minor.

##### Tax Revenue Estimate

Revenue losses under the PITL and the B&CTL would depend on the number and locations of urban incentive zones designated and the tax liability of taxpayers qualifying for this credit.

Because this bill would allow an unknown number of urban incentive zones to be designated and does not state the size of these zones or how long this credit would be effective, it is not possible to determine the potential impact. However, for every \$100 million of costs that would qualify taxpayers for either the 20% or 30% credit would result in revenue losses of \$20 to \$30 million.

Based on existing programs, the potential growth of these projects could escalate into much larger revenue losses in future years.

#### BOARD POSITION

Pending.

Attachment A  
AB 601  
As Introduced February 19, 1999

ECONOMIC DEVELOPMENT AREA TAX INCENTIVES

**Sales or Use Tax Credit**

The sales or use tax credit is allowed for an amount equal to the sales or use taxes paid on the purchase of qualified machinery purchased for exclusive use in an economic development area (except MEA). The amount of the credit is limited to the tax attributable to economic development area income. Qualified property is defined as follows:

**Enterprise Zone:**

- Machinery and machinery parts used for:
  - manufacturing, processing, assembling, or fabricating;
  - producing renewable energy resources; or
  - air or water pollution control mechanisms.
- Data processing and communication equipment.
- Certain motion picture manufacturing equipment.

**LAMBRA:**

- high technology equipment (e.g., computers);
- aircraft maintenance equipment;
- aircraft components; or
- certain depreciable property.

**TTA:**

- Machinery and machinery parts used for:
  - manufacturing, processing, assembling, or fabricating;
  - producing renewable energy resources; or
  - air or water pollution control mechanisms.
- Data processing and communication equipment.
- Certain motion picture manufacturing equipment.

In addition, qualified property must be purchased and placed in service before the economic development area designation expires. The maximum value of property that may be eligible for the enterprise zone, LAMBRA, and TTA sales or use tax credit is \$1 million for individuals and \$20 million for corporations.

**Hiring Credit**

A business located in an economic development area may reduce tax by a percentage of wages paid to qualified employees. A qualified employee must be hired after the area is designated as an economic development area and meet certain other criteria. At least 90% of the qualified employee's work must be directly related to a trade or business located in the economic development area and at least 50% must be performed inside the economic development area. The business may claim up to 50% of the wages paid to a qualified employee as a credit against tax

imposed on economic development area income. The credit is based on the lesser of the actual hourly wage paid or 150% of the current minimum hourly wage (under special circumstances for the Long Beach enterprise zone, the maximum is 202% of the minimum wage). The amount of the credit must be reduced by any other federal or state jobs tax credits and the taxpayer's deduction for ordinary and necessary trade or business expenses must be reduced by the amount of the hiring credit. Certain criteria regarding who may be qualified employees and certain limitations differ between the various economic development areas.

### **Business Expense Deduction**

A business located in an economic development area (except the MEA) may elect to deduct as a business expense a specified amount of the cost of qualified property purchased for exclusive use in the economic development area. The deduction is allowed in the taxable or income year in which the taxpayer places the qualified property in service. For LAMBRA businesses, the amount of the deduction is added back to the taxpayer's income if at the close of the second year the taxpayer does not have a net increase of one or more jobs (defined as 2,000 paid hours per employee per year). The property's basis must be reduced by the amount of the deduction. For enterprise zones, LAMBRAs, and TTA the maximum deduction for all qualified property is the lesser of 40% of the cost or the following:

If the property was placed in service:

Months after designation	Maximum deduction
0 to 24	\$40,000
25 to 48	30,000
48 and over	20,000

### **Net Operating Loss Deduction**

A business located in an economic development area may elect to carry over 100% of the economic development area net operating losses (NOLs) to deduct from economic development area income of future years. The election must be made on the original return for the year of the loss. The NOL carryover is determined by computing the business loss that results from business activity in the economic development area.

### **Net Interest Deduction**

A deduction from income is allowed for the amount of net interest earned on loans made to a trade or business located in an enterprise zone. Net interest is defined as the full amount of the interest less any direct expenses (e.g., commission paid) incurred in making the loan. The loan must be used solely for business activities within the enterprise zone and the lender may not have equity or other ownership interest in the enterprise zone trade or business. This incentive is not available for LAMBRAs, TTA or MEA.

### **Enterprise Zone Employee Wage Credit**

Certain disadvantaged individuals are allowed a credit for wages received from an enterprise zone business. Public employees are not eligible for the credit. The amount of the credit is 5% of "qualified wages," defined as wages subject to federal unemployment insurance. For each dollar of income received by the taxpayer in excess of qualified wages, the credit is reduced by nine cents. The credit is not refundable and cannot be carried forward. The amount of the credit is limited to the amount of tax that would be imposed on income from employment in the enterprise zone, computed as though that income represented the taxpayer's entire taxable income. This incentive is not available for LAMBRAs, TTA, or MEA.

### **Apportioning**

For businesses operating inside and outside an economic development area, the amount of credit or net operating loss deduction that may be claimed is limited by the amount of tax or income attributable to the economic development area. Income is first apportioned to California using the same formula as that used by all businesses that operate inside and outside the state (property, payroll, a double-weighted sales factor). This income is further apportioned to the economic development area using a two-factor formula based on the property and payroll of the business.