

ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: O'Connell Analyst: Kristina North Bill Number: SB 680

Related Bills: See legislative history Telephone: 845-6978 Introduced Date: February 24, 1999

Attorney: Doug Bramhall Sponsor: _____

SUBJECT: 1999 California Land & Water Conservation Act/Qualified Contributions Credit

SUMMARY

This bill would establish the California Land and Water Conservation Act of 1999 within the Public Resources Code (PRC) and would establish tax credits within the Revenue and Taxation Code. This analysis addresses the provisions of the bill that pertain to the tax credits.

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&TCL), this bill would allow a tax credit to taxpayers who donate real property (as defined) to the state, approved local governments, or approved nonprofit organizations designated by the state or local government. The amount of tax credit would equal 55% of the fair market value (FMV) of the qualified contribution.

EFFECTIVE DATE

This bill would apply a qualified contribution made on or after January 1, 2000.

LEGISLATIVE HISTORY

SB 2080 (1998); SB 87 (1997); SB 1280 (1995/1996)

SPECIFIC FINDINGS

Current federal and state tax laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child and dependent care credits) or to influence business practices and decisions or achieve social goals. Credits generally are based on a percentage of tax expenditures by the taxpayer. Currently, no existing federal and state laws provide income tax credits for the contribution of property to state or local governments. Additionally, no federal or state laws provide a tax credit for up to 55% of the value of property, without regard to the original cost or current tax basis of such property to the taxpayer.

Under **current federal and California state laws**, contributions of property qualify as charitable contributions if the property is contributed to or for the use of qualified organizations (public, private or governmental), as follows:

- ◆ For corporations, **existing federal and state laws** allow a deduction for charitable contributions, limited to 10% of the taxpayer's net income (except as specified).

Board Position:

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_____ N	_____ OUA	_____ X PENDING

Department Director

Date

Gerald Goldberg

4/6/1999

Contributions in excess of 10% may be carried over to the following five succeeding income years. Under state law, the amount of a contribution is limited to a taxpayer's basis in the property contributed.

- ◆ For individuals, both **federal and state laws** allow a deduction for charitable contributions. The amount generally deductible for a contribution of appreciated real property (normally capital gain property) is equal to the FMV of the property on the date of contribution. For contributions to certain types of charitable organizations, including governmental units, the allowable deduction is limited to 50% of the taxpayer's adjusted gross income (AGI). However, for other types of charitable organizations, the deduction may be limited to 30% of the taxpayer's AGI. If the charitable contribution amount exceeds 50% (or 30%) of the taxpayer's AGI, the taxpayer may carry over the excess amount up to five years.

For a charitable gift of ordinary income-type property, the amount considered contributed (the property's FMV) must be reduced by the amount of ordinary income or short-term capital gain that would have been recognized if the property had been sold by the donor for its FMV.

Ordinary income-type property is property, such as inventory, which would have resulted in some amount of gain, other than long-term capital gain, if sold at its FMV on the date it was contributed.

California law generally conforms to federal law relating to gain or loss on the disposition of capital assets. **Federal and state law** provide that capital assets are property other than: stock in trade or other inventory-type property held primarily for sale to customers; depreciable or real property used in a trade or business (i.e., "Section 1231 Property"); copyrights and other literary property; accounts or notes receivable acquired in the ordinary course of business; and U.S. government publications, as specified.

Generally, capital gain is realized when a capital asset is sold or exchanged and the amount realized exceeds the adjusted basis of the asset (and, in certain situations, the amount subject to recapture under federal law). Adjusted basis in a capital asset is generally determined by the costs of the asset (when capital assets are acquired in certain non-recognition transactions, adjusted basis may be a carryover or substituted basis) and is increased by further investment or decreased by allowable deductions (such as depreciation). Capital losses occur when a capital asset is sold or exchanged and the amount realized is less than the adjusted basis of the asset. Generally a gain or loss from the sale or other disposition of property that does not qualify as a capital asset is ordinary gain or loss (other than gain from the sale of Section 1231 property), and similarly, a sale or other disposition of a capital asset in a transaction that does not qualify as a "sale or exchange" also generates ordinary income.

Under recent amendments to **federal law**, the maximum tax rate applicable to net capital gains for assets held more than one year was reduced from a maximum rate of 28% to 20% and to 10% for individuals, estates, and trusts who would pay tax at the 15% marginal tax rate. Beginning after the year 2000, **federal law** reduces these maximum capital gains rates for individuals to 18% (for those who would otherwise pay 20%) and 8% (for those who would otherwise pay 15%), provided the asset had been held more than five years.

Under **current state tax law**, capital gains for corporate and noncorporate taxpayers are taxed at the same rates as ordinary income, with no reduced capital gain rate (except that current PITL contains a 50% exclusion for gain recognized from the sale of qualified small business stock).

This bill would establish the California Land and Water Conservation Act of 1999 to encourage donations of land to the state, local governments, or designated nonprofit organizations.

This bill would require that each application for contribution must meet the federal charitable contribution deduction provisions. The Secretary of the Resources Agency (Secretary) cannot accept any property until he or she has sought and received a written opinion from the Franchise Tax Board (FTB) that the property contribution would qualify as a charitable contribution under federal income tax law. If the contribution is approved by the Secretary, the contributor of the property may receive a credit equal to 55% of the property's FMV.

This bill would require the California Legislature to appropriate 55% of the FMV of the property contributed to the recipient department before the Secretary could approve the contribution. The recipient department would be required to transfer the appropriation to the California Personal Income Tax or Bank and Corporation Tax Fund after the Secretary's final approval of the contribution.

Under both the PITL and the B&CTL, **this bill** would provide that, in the case of any pass-through entity (i.e., partnership or S corporation), the FMV of the qualified contribution would be passed through to the partners or shareholders of the pass-through entity in accordance with their interest in the entity as of the date of the qualified contribution.

This bill would require the Secretary to provide an annual listing to the FTB containing the names, taxpayer identification numbers, including taxpayer identification numbers for each partner or shareholder, description of property and total amount of credit approved for each donor.

The credit must be reduced by an amount equal to the FMV of any property interests or other consideration received by the taxpayer in exchange for the contribution.

Under both the PITL and the B&CTL, the credit could reduce regular tax below tentative minimum tax for AMT purposes.

Any credit in excess of tax could be carried forward to reduce tax liability in subsequent years until the credit amount is exhausted.

The credit would be in lieu of any other state credit or deduction that the taxpayer would otherwise be allowed for the contributed property or interest therein.

Policy Considerations

This bill does not include a sunset date or limit the number of years for the carryover. Credits are typically enacted with a repeal date to ensure that the Legislature reviews their effectiveness.

When a sunset date is provided, carryovers are usually limited since credits typically are utilized within eight years of being earned. Recent credits have been enacted with a carryover limit so the department is not required to retain the credit carryover on the tax forms indefinitely after its repeal date.

This bill would provide a credit for donating land and/or water rights equal to 55% of the value of the property, making a land contribution potentially six to eight times more valuable than any other kind of donation. Additionally, in combination with the federal deduction for a charitable contribution, this credit could provide some taxpayers with tax benefits of almost 95% of the value of the donated land or water rights. However, the greater value of this incentive appears consistent with the intent of providing a major inducement for land owners to donate property for conservation purposes and to indirectly use federal dollars for part of the costs.

The department does not administer the Internal Revenue Code; therefore, an FTB opinion whether a contribution of property would qualify as a charitable contribution pursuant to federal law would be advisory. In a comparable bill considered last year, this issue was addressed by a provision in that bill which precluded the FTB from issuing an opinion unless it either had received a formal Internal Revenue Service (IRS) ruling or a copy of a formal ruling issued by the IRS to a California taxpayer on the deductibility of the contribution.

Implementation Considerations

The department could implement the provisions of this bill pertaining to the tax incentives.

Technical Considerations

The actual credit language allows taxpayers a credit equal in amount to "55% of the FMV of any qualified contribution"; however, the contribution procedure under the PRC requires the Secretary of the Resources Agency to annually provide a list of taxpayers who qualify for the credit and the credit amount. To eliminate the potential for disputes between the department and taxpayers, the Revenue and Taxation Code credit language should eliminate the reference to FMV and instead directly tie the allowable credit amount for each taxpayer to the amount certified by the Secretary of the Resources Agency. Otherwise, in circumstances where a taxpayer is able to obtain an appraisal of FMV that differs from that assumed by the Secretary of the Resources Agency in certifying a credit amount, the department may be unable to limit a particular taxpayer's actual credit to the amount certified and budgeted by the Legislature under the procedure set forth in the PRC.

FISCAL IMPACT

Departmental Costs

It is not anticipated that providing written opinions to verify that the contributions meet the federal charitable contribution laws would immediately require additional staff positions; however, should the level of qualified property contributions increase, additional staff may be required.

Tax Revenue Estimate

This bill is estimated to impact PIT and B&CT revenue as shown in the following table. It was assumed no approvals and completions prior to June 30, 2000, and "rule-of-thumb" estimates are provided for beginning with 2000/2001.

Note: This bill would have no revenue impact unless the Legislature appropriates the money, as specified under this bill.

Fiscal Year Cash Flow Impact Effective 1/1/2000 \$ Millions			
Assumption	2000/2001	2001/2002	2002/2003
\$ 50 Million In Donated Property	(\$20)	(\$25)	(\$30)
\$100 Million In Donated Property	(\$40)	(\$50)	(\$55)
\$200 Million In Donated Property	(\$85)	(\$105)	(\$110)

- Rounded to the nearest \$5 million

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

The revenue impact for this bill will be determined by the value of property that might be donated in any given year and the tax liabilities of donors for applying tax credits.

This estimate was developed in the following steps. First, three possible total FMV donation amounts were assumed: \$50 million, \$100 million, and \$200 million in qualified property for each fiscal year. Second, the amount of credit is 55% of the FMV. Third, the contributors would be able to use 75% of the qualified credit amount per year. Unused carryover credits were applied at the rate of 75% per year. It is assumed that many of the taxpayers donating property under the provisions of this bill would have held the property for long periods of time and would not have sold or donated the property except for the combined incentive provided by this bill and federal law. Thus, the amount of gains that would otherwise have been reported on sales of the property is unknown, but is not expected to be particularly significant.

BOARD POSITION

Pending.