

ANALYSIS OF AMENDED BILL

Author:	<u>Eduardo Garcia & Medina, et al.</u>	Analyst:	<u>Diane Deatherage</u>	Bill Number:	<u>AB 2647</u>
	<u>See Legislative</u>			Introduced Date:	<u>February 19, 2016</u>
Related Bills:	<u>History</u>	Telephone:	<u>845-4783</u>	Amended Dates:	<u>March 29, & April 12, 2016</u>
		Attorney:	<u>Bruce Langston</u>	Sponsor:	<u></u>

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.

This analysis only addresses the provisions of this bill that impact the department's programs and operations.

RECOMMENDATION

No position.

Summary of Amendments

As introduced on February 19, 2016, the bill would establish a California New Markets Tax Credit.

The March 29, 2016, amendments added a co-author, modified the operative date, changed administering agency, revised the application process, and made various non-substantive changes.

The April 12, 2016, amendments corrected references, modified the operative and repeal dates, revised information that would be reported to the administering agency, and made various non-substantive changes.

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

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 specifically operative for taxable years beginning on or after January 1, 2017, and before January 1, 2022.

FEDERAL/STATE LAW

The federal New Markets Tax Credit is generally 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).

The federal New Markets Tax Credit was recently extended for five years at \$3.5 billion annually through 2019.¹

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: (1) the entity ceases to be a 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 Development Entity.

¹ Protecting Americans from Tax Hikes Act of 2015, (P.L. 114-113, 12/18/2015).

Introduced February 19, 2016, & Amended March 29, & April 12, 2016

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 regulations 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 that 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 federal 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

Introduced February 19, 2016, & Amended March 29, & April 12, 2016

(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 federal New Markets Tax Credit program can be found in Exhibit A, as attached.

California does not conform to the federal New Markets Tax Credit.

As mentioned above, the Community Development Financial Institution Fund grants the allocation of the federal New Markets Tax Credits. This fund is also used as part of the federal Community Development Financial Institution Program, where the fund provides monetary awards directly to the Community Development Financial Institutions.

Existing California law provides a 20 percent state credit for each “qualified investment” in a California “community development financial institution.” Unlike the federal Community Development Financial Institution Program, the “qualified investment” in the California Community Development Financial 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 Community Development Financial 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 group 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, 2017, and before January 1, 2022, 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, 2022.

The credit would mirror the federal New Markets Tax Credit provisions, with the following modifications:

- Authorize the Responsible Tax Credit Administrator (Credit Administrator) to administer the California New Markets Tax Credit Program. The Credit Administrator would be designated by the Governor.
- Replace references to “Secretary” with “RTCA”² for allocation of the limitation.
- 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.
- Require that a CA Development Entity be an entity that has an allocation agreement dated on or after January 1, 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.
- 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 to 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.
- Allow startup businesses to be considered a qualified active low-income community business for California purposes.
- 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. This requirement would not apply to a business that is controlled by, or under common control with, a federally recognized tribe.

² “RTCA” is the acronym for Responsible Tax Credit Administrator (Credit Administrator).

Introduced February 19, 2016, & Amended March 29, & April 12, 2016

- Provide that businesses that derive 15 percent or more of its annual revenue from the rental or sale of real estate would be excluded from qualifying as a qualified low-income community business, except if the business is controlled by, or under common control with, a second business that (1) does not derive 15 percent or more of its annual revenue from the rental or sale of real estate and (2) is the primary tenant of the real estate leased from the first business.
- Provide that certain types of businesses would be excluded from qualifying as a qualified active low-income community business (i.e., country club, gaming establishment, massage parlor, liquor store, golf course, charter school, or a sexually oriented business).
- Require recapture by reference to federal provisions with some modifications.
- 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 allocation of authority to designate qualified equity investments for each calendar year based upon credits of up to \$40 million, in addition to any undesignated or reissued allocations of authority to designate qualified equity investment from the prior year.

This bill would require the Credit Administrator to accept applications on or before May 15, 2017, and award authority to designate qualified equity investments annually through 2021.

The Credit Administrator would be required to establish and impose reasonable fees upon entities that apply for the authority to designate qualified equity investments and develop guidelines to adopt an allocation process that would do the following:

- Create an equitable distribution process for allocation of the authority to designate qualified equity investments;
- Set minimum organizational capacity standards;
- Require annual reporting to the Credit Administrator by each CA Development Entity that receives an allocation; and
- Provide that any allocation of undesignated qualified equity investments is returned to the Credit Administrator for subsequent reallocation.

The Credit Administrator would develop guidelines for its responsibilities with respect to the allocation of the qualified equity investments and establish, in consultation with the Franchise Tax Board (FTB), a process for recapture of the credit.

A CA Development Entity would provide the Credit Administrator with the name, address, and tax identification number of each investor and entity for which an authority to designate qualified equity investments was allocated by the CA Development Entity. The Credit Administrator would provide this information to the FTB in a manner determined by the FTB.

The Credit Administrator would be required to post the information, on its Web site, from the annual reporting by the CA Development Entities and the geographic distribution of the qualified active low-income community businesses assisted.

Introduced February 19, 2016, & Amended March 29, & April 12, 2016

This bill would create the California New Markets Tax Credit Fund for the fees imposed on CA Development Entities that apply for the allocation of the authority to designate qualified equity investments. The Credit Administrator would only make awards in a calendar year in which the Legislature appropriates funds from the California New Markets Tax Credit Fund.

The credit would only be allowed for taxable years in which moneys are appropriated to the Credit Administrator to administer the California New Markets Tax Credit. For those years in which moneys are appropriated, the Credit Administrator shall post a notice of the appropriation on its Internet web site homepage and send such notice to the Secretary of State and Legislative Counsel.

This bill would add severability language that would, upon a provision or application of a provision being invalidated by a court, allow the remaining provisions to remain in effect.

To comply with Revenue and Taxation Code section 41,³ the bill lists:

- Specific goals, purposes, and objectives - to attract private sector investment in lower income communities in California.
- Performance indicators –
 - Amount of qualified low-income community investments issued.
 - Amount of dollars deployed in qualified low-income community investments.
 - Number of operating businesses assisted as a result of qualified low-income community investments.
 - Number of employment positions created and retained as a result of qualified low-income community investments and the average annual salary of those positions.
- Data collection requirements and baseline measurements –
 - Baseline measurements include the amount of tax credits issued in the year, the unemployment rate of the area, and the poverty rate of the area.
 - Data to collect includes the amount of tax credits issued in the year, the number of operating businesses in a low-income community assisted, and the number of jobs created and retained as a result of qualified low-income community investments.

³ Under Revenue and Taxation Code section 41, legislation that would create a new tax credit is required to include specific goals, purposes, objectives, and performance measures to allow the Legislature to evaluate the credit's effectiveness.

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 a phrase that is undefined, i.e., "common control." The absence of a definition to clarify this term could lead to disputes with taxpayers and would complicate the administration of this bill. The author may want to amend the bill to clearly define the phrase.

It is unclear what "recapture process" would need to be established by the Credit Administrator and the FTB. Lack of clarity could lead to disputes between the agencies and taxpayers. The author may want to amend the bill to provide recapture rules.

In the event of a dispute regarding the recapture process, there is no legislative authority for the FTB to disclose taxpayer information to the Credit Administrator. State law prohibits the disclosure of any taxpayer information except as specifically authorized by statute. The bill should be amended to include specific authority to allow the FTB to disclose this information to the Credit Administrator.

TECHNICAL CONSIDERATIONS

The bill would be repealed by its own terms prior to the expiration of the Credit Administrator's authority to designate qualified investments. This bill should be amended to resolve this inconsistency.

The bill would allow the credit for taxable years beginning on or after January 1, 2017, and before January 1, 2022; however the award cycles would be from 2017 through 2021. If an award is designated in 2021, the taxpayer would not be able to utilize this credit.

A grammatical error exists and should be corrected by inserting "of" after "land" (page 6, line 14; page 16, line 22; and page 27, line 1).

LEGISLATIVE HISTORY

AB 185 (Eduardo Garcia and Medina, 2015/2016), substantially similar to this bill, would have created a California New Markets Tax Credit Program that would have been administered by the Governor's Office of Business and Economic Development. AB 185 failed to pass out of the Assembly Appropriations Committee.

AB 1399 (Medina, and V. Manuel Pérez, 2013/2014), substantially similar to this bill, would have created a California New Markets Tax Credit Program, that would have been administered by the California Competes Tax Credit Committee and the Governor's Office of Business and Economic Development. AB 1399 was vetoed by the Governor due to the cost as he stated that a bill to spend \$200 million should be considered with other priorities during the annual budget process.

Introduced February 19, 2016, & Amended March 29, & April 12, 2016

AB 305 (V. Manuel Pérez, et al., 2013/2014) would have reduced the total amount of the New Jobs Tax Credit and created a 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 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 \$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 California New Markets Tax 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

This bill would impact the department's printing, processing, and programming costs. 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

This bill would result in the following revenue loss:

Estimated Revenue Impact of AB 2647 As Amended April 12, 2016 Assumed Enactment After June 30, 2016 (\$ in Millions)				
2016-17	2017-18	2018-19	2019-20	2020-2021
\$0.0	\$0.0	-\$1.5	-\$4.6	-\$7.9

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill. In addition, this estimate only reflects the revenue impact to income and franchise taxes.

Revenue Discussion

This bill would establish the California New Markets Tax Credit Program for investments in businesses that provide capital or loans to low-income communities. This estimate assumes that the \$40 million annual maximum credit allocation would be made available each year from 2017 through 2019. Because the credit sunsets after five years on January 1, 2022, the estimate assumes credit allocations would decline by 10 percent each year through 2019 and that no allocations would be made in 2020 or 2021. It also assumes that of the \$40 million available, \$21 million in credit allocation would occur in 2017, \$18 million in 2018, and \$16 million in 2019. These allocations would be available to offset income and franchise taxes, and the remainder would be either used to offset insurance taxes or remain unallocated.

The bill specifies the applicable percentage as zero in the first two years, 7 percent in the third year, and 8 percent in the fourth through seventh years for a total of 39 percent of the investment. Because the sunset date would terminate the generation of additional credits, there would be a reduction in the cumulative percentage of credit allowed per allocation year. The cumulative credit would be reduced to 23 percent for investments made in 2017, 15 percent for 2018, and 7 percent for 2019. The remaining credits would no longer be available for use by the taxpayer. Based on these credit percentage limitations and the annual allocation estimates, the 2017 investments would generate \$3.7 million in credits for 2019 peaking in 2021 at approximately \$10.8 million.

The estimates were converted to fiscal year estimates, and then rounded to arrive at the amounts reflected in the table above.

LEGAL IMPACT

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 would provide an indirect subsidy by encouraging these loans over investments in federal securities and 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

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 a private investor may receive a possible excessive return at the expense of meaningful community benefits.

POLICY CONCERNS

This bill would allow a taxpayer to obtain combined federal and state credits of up to 74 percent of the investment even in cases where the federal credit alone would make the CA 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 CA Development Entity may market the state credit.

A credit whose availability is subject to an annual budget appropriation may lack the certainty taxpayers require to invest in low-income communities.

LEGISLATIVE STAFF CONTACT

Diane Deatherage
Legislative Analyst, FTB
(916) 845-4783
diane.deatherage@ftb.ca.gov

Jame Eiserman
Revenue Manager, FTB
(916) 845-7484
jame.eiserman@ftb.ca.gov

Gail Hall
Legislative Director, FTB
(916) 845-6333
gail.hall@ftb.ca.gov

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.

