

ANALYSIS OF AMENDED BILL

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Related Bills:	<u>See Legislative History</u>	Telephone:	<u>845-2551</u>	Amended Date:	<u>March 27, 2017</u>
		Attorney:	<u>Langston Bruce</u>	Sponsor:	<u></u>

SUBJECT: Sale of Qualified Vacant Lot Credit

SUMMARY

This bill would, under the Personal Income Tax Law (PITL) and the Corporation Tax Law (CTL), create a credit for the sale of a qualified vacant lot.

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

RECOMMENDATION – NO POSITION**Summary of Amendments**

The March 27, 2017, amendments removed the bill's provision that would have made nonsubstantive changes relating to capital gains and losses, and replaced it with the provisions discussed in this analysis. This is the department's first analysis of the bill.

REASON FOR THE BILL

The reason for this bill is to incentivize infill development of blighted vacant lots to help ease California's on-going housing crisis.

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, 2018, and before January 1, 2031.

FEDERAL/STATE LAW***Capital Gains***

Federal law¹ provides rules governing the tax treatment of capital gains and losses, identifying holding periods, and determining the gain or loss from the sale or exchange of a capital asset. In general, property held for personal use or investment purposes is a capital asset.²

¹ Internal Revenue Code (IRC) sections 1201 through 1257.

² IRC section 1221(a).

Examples of capital assets include held-for-investment stocks and securities as well as an owner-occupied personal residence.

Generally, capital gain is realized and recognized when a capital asset is sold or otherwise disposed of and the amount realized exceeds the basis of the asset and the amount subject to recapture under federal law. Basis in a capital asset is determined by the cost of the asset and is increased by further investment or decreased by allowable deductions. A capital loss results when a capital asset is sold or otherwise disposed of and the amount realized is less than the basis of the asset. Generally, any gain or loss from the sale or other disposition of property that does not qualify as a capital asset is ordinary gain or loss.

Property used in a taxpayer's trade or business is not a capital asset. However, federal law does provide, under IRC section 1231, that certain dispositions may be treated as a capital asset. IRC section 1231 gains arise from: (1) the sale or exchange of depreciable personal or real property used in a trade or business (not mere investment) and held for more than one year; and (2) the conversion of business or investment property held for more than one year. IRC section 1231 losses are losses from the sale or exchange or conversion of business or investment property held for more than one year. Generally, all IRC section 1231 gains and losses must first be netted against each other in a taxable year. Then, if IRC section 1231 gains exceed IRC section 1231 losses, the net gains are treated as long-term capital gains. If IRC section 1231 losses exceed IRC section 1231 gains, the net losses are treated as ordinary losses. IRC section 1231 gains must be treated as ordinary income to the extent of the taxpayer's net IRC section 1231 losses in the preceding five years.

Federal law (IRC section 1222) provides rules relating to the netting of capital gains and losses. Short-term capital gains are netted with short-term capital losses to arrive at net short-term capital gains/losses. Long-term capital gains are netted with long-term capital losses and net IRC section 1231 gains to arrive at net long-term capital gains/losses. Net short-term capital gains/losses and net long-term capital gains/losses are netted. If a net gain results, then that gain is included in income. If a net loss results, it is not currently deductible for corporations, but up to \$3,000 may be deductible for individuals.

Under federal law, there are circumstances when a portion of a capital gain may be excluded from a taxpayer's gross income. For example, federal law allows a capital gain exclusion from the sale (or exchange) of property owned and used as a principal residence for at least two of the five years before the sale. An individual may exclude up to \$250,000 of gain, while a married couple filing a joint return may exclude up to \$500,000.

Other federal law provisions permit some or all of any realized capital gains to be deferred and recognized at a future date, such as like-kind exchanges under IRC section 1031 and involuntary conversions under IRC section 1033.

Complex rules allow non-corporate taxpayers to apply maximum tax rates that range from 0 percent to 28 percent to the taxation of a net capital gain.³

Under current federal law the tax on net capital gains for corporations is limited to a maximum rate of 35 percent that only applies when the top corporate rate on ordinary income exceeds 35 percent. Since the generally applicable maximum rate on corporate ordinary income for tax year 2016 is 35 percent, this capital gain tax limitation has no current effect.

California generally follows federal law for defining capital assets, identifying holding periods, and determining the amount of gain or loss from the sale or exchange of a capital asset. However, under state law capital gains are taxed at the same rate as *ordinary income* regardless of the holding period of the asset.

Current California law, in Regulation Section 25106.5, relating to combined reporting, provides for the intrastate apportionment of business gains or losses from the sale or exchange of: (1) capital assets; (2) IRC section 1231 property; and (3) involuntary conversions, prior to the IRC section 1221 capital gain/loss netting provisions. Those gain/loss items are then netted at the entity level after intrastate apportionment.

Under state law, capital gains for corporate taxpayers are taxed at the same rates as ordinary income (8.84 percent), with no maximum capital gain rate. Thus, under current federal and state law, corporate taxpayers are taxed on capital gains at the same rates as on ordinary income.

Tax Credits

Existing federal and state 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.

There are currently no federal or state credits comparable to the credit this bill would create.

Under Revenue and Taxation Code (R&TC) 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.

³ Federal Topic 409 *Capital Gains and Losses* <https://www.irs.gov/taxtopics/tc409.html>

THIS BILL

For each taxable year beginning on or after January 1, 2018, and before January 1, 2031, this bill would, under the PITL and the CTL, allow a tax credit to a taxpayer that sells a qualified vacant site. The credit would be equal to:

- Fifty (50) percent of the tax attributable to a capital gain from the sale of a qualified vacant site in the taxable year that it is sold.
- Fifty (50) percent of the tax attributable to a capital gain from the sale of a qualified vacant site in the taxable year that the construction process begins to build housing or a mixed-use development on the qualified vacant site if construction begins no later than five years from the sale of the qualified vacant site.

This bill would define the following terms and phrases:

- A metropolitan county, a micropolitan county, a nonmetropolitan county, and a suburban county would be determined in accordance with Section 65583.2 of the Government Code.⁴
- “Qualified vacant site” means an undeveloped site or a site with a building that has been abandoned for three or more years, that is surrounded by development on two or more sides, and that has any of the following densities approved for development:
 - For a city located in a nonmetropolitan county or for a nonmetropolitan county that has a micropolitan area within it, sites that are approved for the development of at least 15 units per acre.
 - For an unincorporated area in a nonmetropolitan county that does not meet the requirements of Section 65583.2 of the Government Code, sites that are approved for the development of at least 10 units per acre.
 - For a suburban jurisdiction, sites that are approved for the development of at least 20 units per acre.
 - For a city located within a metropolitan county, or for a metropolitan county, sites that are approved for the development of at least 30 units per acre.

This bill would also provide the following:

- More than one taxpayer owns the qualified vacant site, the credit would be allocated among the taxpayers based on percentage of ownership.
- A county assessor, upon request of the taxpayer or the Franchise Tax Board (FTB), would be required to provide a report relating to the use of the qualified vacant site.

⁴ http://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?sectionNum=65583.2.&lawCode=GOV

- Any unused credit could be carried forward for eight years if necessary, until exhausted.
- The credit would be exempt from the requirements of R&TC section 41.
- The FTB could issue any regulations necessary or appropriate to implement the purposes of this section.
- The credit would be repealed by its own terms on December 1, 2031.

IMPLEMENTATION CONSIDERATIONS

Department staff has identified the following implementation considerations for purposes of a high-level discussion; additional concerns may be identified as the bill moves through the legislative process. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

This bill lacks administrative details necessary to implement the credit and determine its impacts to the department's systems, forms, and processes. For example, the amount of the credit and the taxable year the credit would be claimed is unclear.

- Since state law lacks a specified rate applicable for capital gains, it is unclear what is meant by the phrase "tax attributable to a capital gain."
- It is unclear whether the credit would only apply to "sales" of qualified vacant lots, or also to capital gains that result from various tax-deferred transactions, such as like-kind exchanges, involuntary conversions, and certain distributions by entities such as partnerships and corporations of property that may generate capital gains taxes to the distributing entity and also to the recipient partner or shareholder?
- Additionally, if the credit is allowed for tax-deferred transactions, it is unclear whether the credit would apply to the amount of gain realized or recognized and in what year? Absent clarification it could be argued that various tax deferred transactions would allow a taxpayer to later claim this credit when the property is disposed of in a later taxable transaction.

Absent clarification of the above, it is unclear how the department would determine the credit amount. For clarity and ease of administration, the bill should be amended.

This bill uses terms and phrases that are undefined, i.e., "undeveloped site," "building that has been abandoned," "development," "construction process begins," "mixed-use development," etc. The absence of definitions to clarify these terms could lead to disputes with taxpayers and would complicate the administration of this bill. For clarity and ease of administration, it is recommended that the bill be amended.

The department lacks expertise on land use and development. Typically, credits involving areas for which the department lacks expertise are certified by another agency or agencies that possess the relevant expertise. The certification language would specify the responsibilities of both the certifying agency and the taxpayer. It is recommended that this bill

be amended to include a certifying agency, and specify that the following information be included on a certificate that could be provided, upon request, to the FTB:

- The name and taxpayer identification number of both the taxpayer who sells the qualified vacant lot and the purchaser of the qualified vacant lot.
- The physical address and parcel number of the qualified vacant lot.
- The certified credit amount.
- The date of the certification.

Because the bill fails to specify otherwise, the FTB would be subject to the rulemaking procedures required under the Administrative Procedures Act (APA).⁵ Following these procedures may delay the immediate implementation of this bill. To prevent any delay, it is recommended that the author add a provision exempting the FTB from the APA when the FTB is prescribing rules, guidelines, or procedures necessary or appropriate to carry out the bill's purpose.

LEGISLATIVE HISTORY

Research of California legislation found no enacted or proposed legislation similar to the provisions of this bill.

OTHER STATES' INFORMATION

Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York laws do not provide a credit comparable to the credit that would be allowed by this bill. The laws of these states were selected due to their similarities to California's economy, business entity types, and tax laws.

FISCAL IMPACT

The department's costs to implement this bill have yet to be determined. As the bill moves through the legislative process and implementation concerns are resolved, costs will be identified and an appropriation will be requested, if necessary.

⁵ Government Code section 11340 et seq.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue loss:

Estimated Revenue Impact of AB 201 As Amended March 27, 2017 Assumed Enactment After June 30, 2017 (\$ in Millions)		
2017-18	2018-19	2019-20
- \$36	- \$80	- \$90

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

Revenue Discussion

Based on available research, it is estimated that in taxable year 2018 there would be approximately 18,000 qualified vacant sites. Sales of qualified vacant sites for the 2018 taxable year are expected to generate roughly \$1.4 billion in capital gains. With an average tax rate of 9 percent, roughly \$125 million in credits would be generated in the 2018 taxable year. It is assumed that 55 percent, or \$70 million, of the credits would be used in the year generated and the remaining credits would be carried forward and used over the next four years.

The tax year estimates are converted to fiscal year estimates, and then rounded to arrive at the amounts shown in the above table.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some may say that this bill would incentivize owners to sell their vacant lots resulting in the development of new housing stock to alleviate the housing crisis.

Opponents: Some could argue that providing a state credit that would potentially exclude the entire gain from the sale of a qualified vacant lot could be overly broad, and divert limited state resources from other social programs.

POLICY CONCERNS

This bill would allow taxpayers in certain circumstances to claim multiple tax benefits on the sale of a qualified vacant lot.

The credit would be allowed for sales of qualified vacant lots located either inside or outside California.

This bill fails to limit the amount of the credit that may be taken. Credits that could potentially be quite costly are sometimes limited either on a per-project or per-taxpayer basis. This bill could arguably provide a 100 percent credit which would be unprecedented.

This bill would allow 50 percent of the credit to be claimed in the year construction begins rather than in the year the construction project is placed in service and ready for occupancy. The author may wish to amend the language to avoid the possibility that a taxpayer could claim the credit, without the housing or mixed-use development actually being constructed or placed in service. To alleviate this concern, the bill could be amended to require all or some portion of the credit amount to be added back to the tax liability (i.e., "recaptured") should the project not be built within a certain length of time.

Because this bill could grant a credit for business decisions that have already been made, rather than for business decisions made in response to the credit, this bill would include future business decisions and activities for which a binding contract already exists.

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