



Analysis of Amended Bill

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Sponsor:

Bill Number: AB 1259

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Introduced February 21, 2019,
and Amended April 24 &
April 30, 2019

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Related Bills: See Legislative
History

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 would impact the department's programs and operations.

Recommendation – No position.

Summary of Amendments

The April 24, 2019, amendments modified the bill's operative dates and yearly credit percentages, made other technical and clarifying changes to the credit, and allowed the Franchise Tax Board (FTB) to prescribe rules or regulations.

The April 30, 2019, amendments further modified the credit percentages.

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, 2021, and before January 1, 2026, subject to a specific appropriation for the Governor's Office of Business and Economic Development (GO-Biz) to administer the California New Markets Tax Credit.

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 extended 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).

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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 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, 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 section 1391, and is contiguous to one or more low-income communities.

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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 (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.

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.

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.

This Bill

For taxable years beginning on or after January 1, 2021, and before January 1, 2026, this bill would, under the PITL and CTL, allow a California New Markets Tax Credit in modified conformity to the federal credit, as described below.

- Authorize GO-Biz to administer the California New Markets Tax Credit Program.
- Replace references to "Secretary" with "GO-Biz" as the administering agency for allocation of the investment designation limitation.
- Allow a 39 percent credit to be claimed in the following manner:
 - Six percent for the first two credit allowance dates;
 - Three percent on the third credit allowance date; and
 - Six 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.

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- Limit eligibility as a “qualified active low-income community business” to businesses located within census tracts that are located in California and 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.
- 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 fewer employees and is located in one or more California low-income communities. This requirement would not apply to a business that is located in a tribal land trust held communally by a federally recognized tribe and managed by the tribal government.
- 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 business or establishment, liquor store, golf course, charter school, or any business that operates or derives revenues from the operation of a sexually oriented business). Define “sexually oriented business” and “nude.”
- Require recapture by reference to federal provisions with some modifications.
- Allow an aggregate annual amount of allocation of authority to designate qualified equity investments for each calendar year based upon credits of up to \$100 million, in addition to any undesignated or reissued allocations of authority to designate qualified equity investment from the prior year.

GO-Biz would be required to develop guidelines for its responsibilities with respect to the allocation of the qualified equity investments and establish, in consultation with the FTB, a process for recapture of the credit. Recaptured investments would revert back to GO-Biz to be reissued and such amounts would be excluded from the annual or cumulative allocation limitation. The enforcement of the recapture provision would be subject to a six-month cure period.

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GO-Biz would be required to adopt guidelines necessary or appropriate to carry out its responsibilities with respect to the allocation, monitoring, and management of the tax credit program authorized by this bill. GO-Biz would establish and impose reasonable fees upon entities that apply to defray the cost of administering the program. The fees collected would be deposited in the California New Markets Tax Credit Account established by this bill.²

GO-Biz, in developing guidelines, would have the authority to adopt an allocation process that would consider specified items.

GO-Biz would be required to accept applications on or before January 15, 2021, and award authority to designated qualified equity investments annually through 2025. If GO-Biz determines the application has a minor, nonsubstantive error or omission, the applicant would be given five business days to correct the deficiency or provide the omitted information. This bill would prohibit a member of the GO-Biz review committee from having a financial interest, as specified, in any qualified equity investment or other assistance from any applicant.

An approved applicant may transfer all or a portion of its certified qualified equity investment authority to its controlling entity or any subsidiary qualified community development entity of the controlling entity, provided that the applicant and the transferee notify GO-Biz within 30 calendar days of such transfer. The transferee would be subject to the same rules, requirements, and limitations applicable to the transferor.

This bill would specify requirements for the CA Development Entity as follows:

- Within 200 calendar days of GO-Biz sending notice of certification, issue the qualified equity investment and receive cash in the amount certified.
- Within 205 calendar days of the applicant receiving notice of certification, provide GO-Biz evidence of the receipt of the cash investment.
- Failure to meet these requirements would result in the lapse of the certification and lapsed certifications would revert back to GO-Biz.
- Provide GO-Biz with the names of the taxpayers that are eligible to utilize tax credits and any transfer of a qualified equity investment.
- Submit a report to GO-Biz that provides documentation as to the investment of at least 85 percent of the funds being deployed within one year of issuance in a qualified low-income community investments in qualified active low-income community businesses located in California.

² Under R&TC Section 18410.3.

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- Annually report to GO-Biz during the following seven years specified information, and any other information requested by GO-Biz.

GO-Biz 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.

This bill also would do the following:

- Allow credits in excess of a taxpayer's current year tax liability to be carried forward for seven years.
- Prohibit taxpayers claiming the California New Markets Tax Credit from claiming otherwise allowable credits for the same investment.
- Allow the California New Markets Tax Credit in addition to the federal New Markets Tax Credit.

The California New Market Tax credit would only be allocated by GO-Biz for taxable years in which moneys are appropriated to GO-Biz for administration. The appropriation would be required to specifically identify the California New Markets Tax Credit. For those years in which moneys are appropriated, GO-Biz 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 require the FTB to prescribe any rules or regulations that may be necessary or appropriate to implement the program that would be authorized by this bill. The FTB would have access to any documentation held by GO-Biz relative to the application and reporting of the qualified community development entity.

To comply with the reporting and evaluation required by R&TC section 41,³ the bill provides specific goals, purposes, and objectives, as well as performance indicators and data collection requirements.

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.

The credit would be repealed by its own terms as of December 1, 2026.

³ R&TC section 41, requires legislation that would create a new tax credit 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.

It is unclear what "recapture process" would need to be established by GO-Biz 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 GO-Biz. 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 GO-Biz.

This credit would only be operative with a future appropriation for GO-Biz. It is unclear how the department would implement this credit without a sufficiently clear and timely appropriation. For clarity and ease of administration, it is recommended that this bill be amended.

For clarity, the bill should be amended to specify that GO-Biz would be responsible for the collection of data and reporting to satisfy the Section 41 reporting requirement.

GO-Biz would receive from qualified community development entities the names of taxpayers eligible to use the tax credit. For clarity and ease of administration, it is recommended that the bill be amended to require the qualified community development entities to also provide GO-Biz with the taxpayers' addresses and social security numbers or individual taxpayer identification numbers and that this information be provided to the FTB by GO-Biz.

This bill uses terms and phrases that are undefined, i.e., "country club," "gaming establishment," "massage business or establishment," "liquor store," and "golf course." 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.

This bill would create an administrative restriction on the FTB as it would require the FTB to go through the Administrative Procedure Act process to issue non-regulatory guidance in publications and forms. It is recommended that the phrase "any rules or" be removed where it appears in this bill.

Legislative History

AB 2647 (Eduardo Garcia & Medina, et al., 2015/2016), substantially similar to this bill, would have created a California New Markets Tax Credit Program. AB 2647 failed to pass by the constitutional deadline.

AB 185 (Eduardo Garcia and Medina, 2015/2016), substantially similar to this bill, would have created a California New Markets Tax Credit Program. AB 185 failed to by the constitutional deadline.

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 GO-Biz. 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.

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. AB 305 failed to pass 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 similar to those proposed in this bill.

Although *Massachusetts*, *Michigan*, and *Minnesota*, and *New York* 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

The department's costs to implement this bill have yet to be determined. As the bill moves through the legislative process, costs will be identified.

Economic Impact

Revenue Estimate

This bill would result in the following revenue loss:

Estimated Revenue Impact of AB1259 as Amended April 30, 2019
Assumed Enactment after June 30, 2019

(\$ in Millions)

Fiscal Year	Revenue
2019-2020	\$0.0
2020-2021	-\$3.8
2021-2022	-\$13.0

This estimate assumes specific appropriations of funds are made beginning in fiscal years 2019-2020 through 2024-2025.

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill or for the net final payment method of accrual.

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. Because the credit sunsets after five years on January 1, 2026, this estimate assumes that in 2021 allocations would be 75 percent of the \$100 million maximum allowed declining to 15 percent for tax year 2025.

The bill specifies the applicable percentage as 6 percent in the first two years, 3 percent in the third year and 6 percent in the fourth through seventh years for a total of 39 percent of the investment. Because of the sunset date, there is a reduction in the cumulative percentage of credit allowed per allocation year. The cumulative credit would be reduced to 27 percent for investments made in 2021 down to 6 percent for 2025. The remaining credits would not be available for use by the taxpayer. Based on the credit percentage limitations and the annual allocation estimates, the investments would generate roughly \$12 million in 2021 credits and peak in 2025 at approximately \$30 million.

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

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.

Policy Concerns

This bill would allow a taxpayer to obtain combined federal and state credits of up to 78 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.

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