STATE OF CALIFORNIA
Franchise Tax Board

Analysis of Original Bill

Author: Atkins	Sponsor:	Bill Number: SB 451
Analyst: Jessica Deitchman	Phone: (916) 845-6310	Introduced: February 21, 2019
Attorney: Shane Hofeling	Related Bills: See Legislative History	

Subject: Rehabilitation of Certified Historic Building Credit

Summary

This bill would, under the Personal Income Tax Law (PITL) and the Corporation Tax Law (CTL), allow a tax credit for a portion of the costs paid or incurred to rehabilitate certain historic structures.

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

Recommendation – No position.

Reason for the Bill

The reason for the bill is to provide an incentive to taxpayers to rehabilitate historic structures by providing a tax credit to help offset some of the costs associated with the rehabilitation.

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.

Federal/State Law

Federal law, section 47 of the Internal Revenue Code (IRC), allows a credit for the rehabilitation expenses of older and historic buildings.

Current state and federal laws generally allow taxpayers engaged in a trade or business to deduct all expenses that are considered ordinary and necessary in conducting that trade or business.

Existing state law lacks a tax credit for the rehabilitation of property or historical buildings.

This Bill

For taxable years beginning on or after January 1, 2021, and before January 1, 2026, this bill would create a tax credit for the rehabilitation expenses of certain homes and historic buildings determined in accordance with federal law (section 47 of the IRC) except as follows:

- A general 20 percent credit would be allowed for the qualified rehabilitation expenditures of a certified historic structure (other than expenses that qualify for the 25 percent credit), and
- A 25 percent credit would be allowed for the qualified rehabilitation expenditures of a certified historic structure if that structure meets any of the following conditions:
    - The rehabilitated structure is located on certain federal surplus property, surplus state real property, or on surplus land.
    - The rehabilitated structure includes affordable housing for lower-income households.[1]
    - The structure is located in a designated census tract.[2]
    - The structure is part of a military base reuse authority.[3]
    - The structure is a transit-oriented development that is a higher-density, mixed-use development within a walking distance of one-half mile of a transit station.

Unlike the federal credit;

- A state credit would be unavailable for expenditures with respect to a qualified building unless it is a certified historic structure, and
- A state credit would be allowed for qualified rehabilitation expenditure amounts for an owner-occupied residence if:
    - The expenses are determined to have a public benefit in the year of completion, and
    - The credit amount is equal to or more than $5,000 but do not exceed $25,000.

[1] As defined in Section 50079.5 of the Health and Safety Code.
[2] As defined in paragraph (7) of subdivision (b) of Section 17053.73 of the Revenue and Taxation Code (R&TC).
[3] Established pursuant to Title 7.86 (commencing with Section 67800 of the Government Code).

- "Certified historic structure" would have the same meaning as defined in Section 47(c)(3) of the IRC, that is a structure in this state and is listed on the California Register of Historical Resources.
- "Qualified rehabilitation expenditure" would have the same meaning as that term is defined in Section 47(c)(2) of the IRC, except that qualified rehabilitation expenditures may include expenditures in connection with the rehabilitation of a building without regard to whether any portion of that building is or is reasonably expected to be a tax-exempt use property.
- "Qualified rehabilitation expenditure" has the same meaning as that term is defined in Section 47(c)(2) of the IRC and also means rehabilitation expenditures incurred by the taxpayer with respect to a qualified residence for the rehabilitation of the exterior of the building or rehabilitation necessary for the function of that home, including, but not limited to, rehabilitation of electrical, plumbing, or foundation of the qualified residence.

The California Tax Credit Allocation Committee (Allocation Committee), with assistance from the Office of Historic Preservation, would be required to do the following:

- Allocate and certify tax credits.
- Establish application procedures.
- Establish criteria consistent with the requirements of this bill.
- Determine and designate applicants that meet the requirements of this bill.
- Process and approve, or reject, all applications.
- Allocate an aggregate amount of credits, subject to the annual cap, equal to the sum of all of the following:
    - $50,000,000 in tax credits for the 2021 calendar year and each calendar year thereafter, through and including the 2026 calendar year.
    - The unused allocation tax credit amount, if any, for the preceding calendar year.
- Set aside $10,000,000 of tax credits that may be allocated each calendar year for taxpayers in the aggregate, with qualified rehabilitation expenditures of less than $1,000,000. To the extent that this amount is not fully allocated in any calendar year, the unused portion would become available for allocation to other taxpayers.
- Allocate credits awarded to a partnership to the partners of that partnership in accordance with the partnership agreement, independent of how the allocation was done for federal purposes and without regard to the federal rule requiring substantial economic effect for partnership allocations under section 704(b) of the IRC.

- Provide the Franchise Tax Board an annual list of the taxpayers that were allocated a credit, including each taxpayer's taxpayer identification number, and the amount allocated to each taxpayer.
- Establish procedures for the recapture of amounts allocated for a tax credit allowed to a taxpayer for the rehabilitation of a qualified residence if the taxpayer does not use the qualified residence as his or her principal residence within two years after the rehabilitation of the residence.
- Adopt a reasonable fee in an amount sufficient to cover expenses.

In addition, this bill would specify the following:

- No deduction would be allowed for any expense for which a credit is allowed, and if a credit is allowed with respect to property, the basis of that property would be reduced by the amount of the credit.
- Any unused credits could be carried over for up to eight years.
- The credit could reduce the regular tax plus the tax relating to the separate tax on lump-sum distributions, below tentative minimum tax for taxpayers subject to the PITL and the CTL.
- Section 47(c)(1)(C)(ii) of the IRC, relating to special rules for rehabilitation that may be expected to be completed in phases would not apply.
- The recapture provisions described in subsection (a) of section 50 of the IRC would apply when the property (or interest in the property) is sold within the recapture period.[4]
- The credit provisions would remain in effect regardless of the expiration or repeal of Section 47 of the IRC, relating to the federal rehabilitation credit.

The tax credit provisions[5] would remain in effect until December 1, 2026, and as of that date would be repealed.

Implementation Considerations

The department has identified the following implementation concern. Department staff is available to work with the author's office to resolve this and other concerns that may be identified.

[4] The compliance and recapture period for the federal historic credits is five years from the date the property is placed in service. Twenty percent of the recapture risk decreases each year.

[5] R&TC sections 17053.91 and 23691.

The bill would disallow a deduction for any expense for which a credit is allowed. For example, if a credit was allowed for an expense of $100, but only $50 of the expense was included in the credit, the entire $100 would be unable to be deducted. If this is contrary to the author's intent, the bill should be amended.

Technical Considerations

Subdivision (a) of section 17053.91 needs to be amended where the term "percentages" appears, as it should be "percentage" for grammatical consistency with the underlying federal law.

The bill uses in incorrect reference. The reference to IRC 47(c)(1)(C)(ii) should be modified to read IRC 47(c)(1)(B)(ii).

Legislative History

AB 771 (Atkins, 2015/2016) substantially similar to this bill, would have allowed a tax credit for the costs to rehabilitate a historic building. AB 771 failed to pass by the constitutional deadline.

AB 1999 (Atkins, 2013/2014) would have allowed a tax credit substantially similar to this bill. AB 1999 was vetoed by the governor, stating in part; "this bill would require a spending commitment that should be weighed against other important priorities in the upcoming budget."

Other States' Information

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota,* and *New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida and *Michigan* lack a credit comparable to the one created in this bill.

Illinois offers a 25 percent credit for eligible expenditures on the rehabilitation of properties in certain designated zones throughout the state. The minimum investment must be the greater of $5,000 or 50 percent of the purchase price.

Massachusetts provides a credit equal to 20 percent of the qualified rehabilitation costs for income-producing properties and 25 percent of such costs for projects with affordable housing. The program is limited to $50 million, statewide, per year. The minimum investment must be 25 percent of the adjusted basis of the property.

Minnesota allows a credit equal to 100 percent of the federal credit allowed for the rehabilitation of certified commercial property, or a grant equal to 90 percent of the federal credit allowed. The credit is fully refundable, but the applicant must register for the credit before beginning the rehabilitation. The credit sunsets in fiscal year 2021.

New York provides a credit for the rehabilitation of both commercial and residential properties of 20 percent of the costs. The commercial rehabilitation is limited to $5 million in credits per project. The residential credit is limited to $50,000 per project and may be refundable depending on the adjusted gross income of the homeowner. This credit must be claimed in conjunction with the federal credit and sunsets on December 31, 2024.

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 SB451 as Introduced February 21, 2019
Assumed Enactment after June 30, 2019

($ in Millions)

Fiscal Year	Revenue
2019-2020	$0
2020-2021	$0
2021-2022	$0

Credits allocated in 2021 cannot be used until after the building has been placed into service and the retable share becomes available. As a result, credit usage would not begin until 2023.

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 authorize the California Tax Credit Allocation Committee (Allocation Committee) to allocate $50 million annually for the rehabilitation of certified historic structures in California from January 1, 2021, through January 1, 2026. Based on the federal historic tax credit usage as well as historical data on qualifying rehabilitation expenses, it is assumed that the credit would be fully allocated each year by the

Allocation Committee. It is assumed that five percent, or $2.5 million, of the allocation would ultimately be returned to the Allocation Committee due to unforeseen project issues and added to the allocation amount in the following year. Allocated credits cannot be used until after the building has been placed into service. As a result, credit usage would not begin until 2023. Beginning in 2023, the ratable share of the credit would become available over the five year period. It is estimated that the total credit generated for taxable year 2023 would be $43 million with the ratable share available of $8.5 million. It is assumed that 90 percent of taxpayers, including the S corporation adjustment, would have a tax liability to offset with the credit. Of those 85 percent, or $6.5 million, would claim the credit in the year generated and the remaining credit would be claimed over the next several years.

To arrive at the offsetting tax effect of the expense deduction that would otherwise be allowed under current law, it is estimated that qualified taxpayers would be unable to deduct approximately $190 million in qualified expenses in taxable year 2023. Applying an average tax rate of 7 percent results in an offsetting revenue gain of $13 million. This results in an estimated net revenue gain of $6.5 million in taxable year 2023. The amount of the loss would peak at $25 million in taxable year 2027.

The tax-year estimates are converted to fiscal-year revenue estimates and rounded to arrive at the amounts reflected in the above table.

Legislative Staff Contact

Jessica Deitchman
Legislative Analyst, FTB
(916) 845-6310
jessica.deitchman@ftb.ca.gov

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

Jahna Carlson
Acting Legislative Director, FTB
(916) 845-5683
jahna.carlson@ftb.ca.gov