STATE OF CALIFORNIA
Franchise Tax Board

Analysis of Amended Bill

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Subject: Deferral of Capital Gains for Investments in Qualified Opportunity Zones

Summary

This bill would, under the Personal Income Tax Law and the Corporation Tax Law, conform to the Tax Cuts and Jobs Act (Public Law 115-97) (TCJA) specified tax treatment for investment in qualified opportunity zones (QOZ) specifically designated within California.

Recommendation – No position.

Summary of Amendments

The March 27, 2019, amendments removed intent language and added provisions that would conform to the TCJA related to specified tax treatment of income derived from investment within QOZs, including the deferral of capital gains and allowed basis adjustments, limited to designated QOZs within California.

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

Reason for the Bill

The reason for the bill is to increase investment in designated California opportunity zones.

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, 2019.

Federal/State Law

Current federal tax law provides for the temporary deferral of gross income for capital gains reinvested in a qualified opportunity fund (QOF), and the permanent exclusion of capital gains from the sale or exchange of an investment in a QOF. The QOZ program, created by the TCJA, was enacted to spur investment in economically distressed communities. QOZs reduce taxes on capital gains for individuals and businesses who invest in QOFs, which invest in designated opportunity zones. QOZ property includes any QOZ stock, QOZ partnership interest, or any QOZ business property.

Under Internal Revenue Code sections 1400Z-1 and 1400Z-2, there are two primary tax incentives to encourage investment in QOZs. The first tax incentive allows for the temporary deferral of inclusion in gross income for capital gains that are reinvested in a QOF. A QOF is an investment vehicle organized as a corporation or a partnership for the purpose of investing in QOZ property (other than in another QOF) that holds at least 90 percent of its assets in QOZ property. If a QOF fails to meet the 90 percent requirement, unless the fund establishes reasonable cause, the fund is subject to a monthly penalty.

If the investment is held by the taxpayer for at least five years, then the basis is increased by 10 percent of the deferred capital gain. If held for at least seven years, then the basis is increased by an additional five percent of the deferred capital gain. If held until at least ten years, then the basis in the investment increases by the remaining 85 percent of the deferred gain. The election to defer the capital gain can be made for qualified sales that occur before December 31, 2026.

The second tax incentive provides for the exclusion from gross income the post-acquisition capital gain on investments in QOFs that are held for at least 10 years. Specifically, if held at least ten years, then the basis of such investment becomes the fair market value of the investment at the date of such sale or exchange.

In addition to the fund penalty for not meeting the 90 percent test, there are recapture rules should taxpayers prematurely withdraw their investment.

California does not conform to either the deferral or the exclusion of capital gains reinvested or invested in QOF, and current state law lacks similar provisions.

This Bill

This bill would, for taxable years beginning on or after January 1, 2019, conform to the federal provisions allowing for the deferral of capital gains and the basis adjustments related to QOZ property invested in QOFs. However, this bill would limit tax incentives only to investments in a QOF that invest in CA QOZs, which is a QOZ that is located within California. In addition, this bill modifies the federal definition of QOZ business property to business property that is located in a California QOZ.

Further, this bill would restrict the election to defer the capital gains from the sale or exchange of qualified property to qualified sales that occur before December 31, 2026.

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.

The provisions of this bill may allow the gain from the sale of real property to be converted to a gain from the sale of an intangible asset. If this is not the author's intent, the author may want to amend the language to clarify the intent.

This bill lacks a California penalty comparable to the federal penalty if a QOF fails to meet the QOF requirements. If the author's intent is to have a comparable penalty for a QOF's failure to meet the California requirement, then the author may wish to amend the language to provide a comparable penalty.

This bill does not grant the Franchise Tax Board (FTB) the authority to prescribe rules or regulations to administer this QOZ program. The author should consider granting the FTB the regulatory authority to properly administer this program.

Legislative History

Research of California legislation history found no legislation similar to the provisions of this bill.

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 does not impose a capital gains tax.

Illinois, Michigan, and *New York* generally conform to the changes made by the TCJA, including the QOZ program.

Massachusetts and *Minnesota* do not conform to the changes made by the TCJA.

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 SB 635 as Amended March 27, 2019
Assumed Enactment after June 30, 2019

($ in Millions)

Fiscal Year	Revenue
2019-2020	-$160
2020-2021	-$110
2021-2022	-$80

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

Based on data from the Joint Committee on Taxation it is estimated that California investors would defer approximately $1.8 billion of capital gains to invest in California qualified opportunity zones in taxable year 2019. It is assumed that each year through 2025, the deferred capital gain investments would decrease as the deferral benefits expire. Applying a tax rate of 6 percent on these deferrals would result in a revenue loss of approximately $110 million for the 2019 taxable year and decrease to $23 million in taxable year 2025. There would be a partial offsetting revenue gain in taxable year 2026 when taxpayers are required to recognize the deferred gains. Additional losses would occur in 2029 when the investment basis is stepped up to fair market value. The tax year estimates are converted to fiscal year revenue estimates, rounded and reflected in the above table.

Legal Impact

This bill would restrict the tax credit to activities in California QOZs. This bill could raise constitutional concerns under the Commerce Clause of the United States Constitution because it could appear to improperly favor in-state activity over out-of-state activity. On August 28, 2012, (*Cutler* v. *Franchise Tax Board*), the Court of Appeal issued a unanimous opinion holding that California's Qualified Small Business Stock (QSBS) statutes were unconstitutional. Specifically, the Court of Appeal held that the QSBS statutes were found to unconstitutionally deny the taxpayer the benefit due to expansion of its activities outside of California.

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