DEPARTMENT OF FINANCE BILL ANALYSIS

AMENDMENT DATE: June 28, 2010
POSITION: Oppose
BILL NUMBER: SB 1316
AUTHOR: G. Romero

BILL SUMMARY: Income Taxes: Property Exchanges: Investment: Credits

For tax year 2011, this bill would 1) create the California New Markets Tax Credit Program to confer tax credits for investments in businesses that provide capital or loans to low-income communities, and 2) eliminate like-kind exchange tax benefit treatment where non-California real property is received in exchange for California real property.

FISCAL SUMMARY

The Franchise Tax Board (FTB) estimates the provisions of this bill would have a net revenue neutral impact on the General Fund and would not significantly impact the FTB's costs. However, if a court were to strike the provision regarding out-of-state like-kind exchanges, our entire tax year loss under the remaining provision could be in incurred resulting in a $7 million loss in General Fund revenue.

COMMENTS

The Department of Finance opposes this bill because of the following legal and constitutional concerns expressed by the FTB:

- The New Market Tax Credit Program would allow a credit for investment in entities that make loans to entities engaged in a trade or business in low-income communities, and would provide an indirect subsidy to non-federal loans, which could result in a violation of the federal law prohibiting discriminatory state taxation of interest on federal securities.
- The New Market Tax Credit Program criteria that a corporation must be a domestic corporation may present constitutional concerns by discriminating against foreign commerce.
- The like-kind exchange provision would disallow gain deferral treatment of an exchange of out-of-state real property for California real property. This provision is likely to be subject to a constitutional challenge and could be expected to be interpreted by the courts as unlawful discrimination against out-of-state taxpayers under the commerce clause of the U.S. Constitution. If this provision were to be stricken down after the 2011 credits have been allocated, a $7 million net revenue loss could result.

Analyst/Principal	Date	Program Budget Manager	Date
(0723) C. Angaretis		Mark Hill	

Department Deputy Director	Date

Governor's Office:	By:	Date:	Position Approved_______
			Position Disapproved

ANALYSIS

A. Programmatic Analysis

1) California New Markets Tax Credit Program (Revenue Loss Provision)

Under current federal law, a "new markets tax credit" (NMTC) is allowed for a taxpayer's qualified equity investments to acquire stock or a similar equity interest in a community development entity (CDE). The CDE'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 NMTC equals 39 percent of the qualified equity investment made in the CDE and is taken over seven years.

Current state law does not conform to the federal NMTC. A 20-percent state credit is allowed for each qualified investment in a California "community development financial institution" (CDFI). The qualified investment in the California CDFI must be at least $50,000, be for a minimum duration of five years, and may consist of either a deposit or loan that does not earn interest or an equity investment.

A California CDFI is defined as a private financial institution located in California and certified by the California Organized Investment Network (COIN) that has community development as its primary mission and lends in urban, rural, or reservation-based communities in California.

California law provides for a recapture of the CDFI credit if the qualified investment is reduced or withdrawn before the end of the five-year period.

The current CDFI credit will cease to be operative for taxable years beginning on or after January 1, 2012.

This provision would, for taxable years beginning on or after January 1, 2011, and before January 1, 2012, allow a tax credit equal to 39 percent of a qualified equity investment (QEI) for a taxpayer that holds a QEI on a credit allowance date. A credit allowance date is the date the investment is initially made.

This provision would cap the aggregate amount of credits for any calendar year at an amount equal to 100 percent of the estimated aggregate revenue increase in the same calendar year as a result of the disallowance of like-kind exchange treatment, as specified in the second provision of this bill.

This provision provides various definitions including the following:

- QEI means any equity investment in a qualified community development entity (QCDE) if all the following conditions are met:
  - The investment was acquired for cash at its original issue or subsequently.
  - Substantially all of the cash is used by the QCDE to make investments in low-income communities. (This requirement is met if at least 85 percent of the assets of the QCDE are invested in low-income community investments.)
  - The investment is designated by the QCDE.
- Equity investment means any stock, other than nonqualified preferred stock, in a corporation, or any capital interest in a partnership.
- QCDE means a domestic corporation or partnership that meets all of the following conditions:
  - Has as its primary mission serving or providing investment capital for low-income communities or low-income persons located in California.

- Maintains accountability to residents of low-income communities through representation on a governing board, an advisory board, or other similar community body.
- Is certified by the Treasurer as being a QCDE.

This provision provides additional rules that would do all of the following:

- Require a recapture credits previously utilized to reduce tax if the QCDE redeems the investment, the investment ceases to be used in the required manner, or the QCDE ceases to be a QCDE.
- Disqualify the business if the corporation repurchases its own stock.
- Allows the Treasurer to reallocate unused credits if not used within five years.

This provision does not provide for a carryover of unused credits by the taxpayer.

DISCUSSION:

The FTB notes that federal law prohibits discriminatory state taxation of interest 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. This incentive, which provides an indirect subsidy to non-federal loans, could result in a violation of the federal law prohibiting discriminatory state taxation of interest on federal securities.

Also, the FTB notes that this provision's criteria that a corporation must be a domestic corporation (to be a QCDE) may present constitutional concerns by discriminating against foreign commerce if the term "domestic" means "U.S.", or by discriminating against interstate commerce if the term "domestic" means "California" (as would be the case if Corporations Code definition applies). This issue also arises under "S" corporation rules.

2) Elimination of Like-Kind Exchange Treatment (Revenue Gain Provision)

Under current federal law, an exchange of property, like a sale, generally is an immediately taxable event. However, no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged for property of a "like-kind" that is to be held for productive use in a trade or business or for investment. This is commonly known as a 1031 exchange. If Internal Revenue Code (IRC) section 1031 applies to an exchange of properties, the basis of the property received in the exchange is equal to the basis of the property transferred, and further adjusted for any gain or loss recognized on the exchange.

Current state law, for taxable years beginning on or after January 1, 2010, conforms to IRC section 1031 as of the specified date of January 1, 2009, relating to exchange of property held for productive use or treatment, with modifications.

This provision would exclude from like-kind exchange treatment for exchanges where non-California real property is received in exchange for California real property for taxable years beginning on or after January 1, 2011, and before January 1, 2012.

DISCUSSION:

This provision would disallow gain deferral treatment of an exchange of out-of-state real property for California real property. The FTB has noted that this provision is likely to be subject to a constitutional

AUTHOR	**AMENDMENT DATE**	**BILL NUMBER**
G. Romero	June 28, 2010	SB 1316

challenge and could be expected to be interpreted by the courts as unlawful discrimination against out-of-state taxpayers under the commerce clause of the U.S. Constitution.

The FTB looked at other states' with similar like-kind exchange history and found that prior to 2001 Oregon limited non-recognition treatment for transactions involving in-state replacement property. The Oregon Supreme Court considered the constitutionality of limiting the non-recognition treatment and the statute was repealed. Georgia and Mississippi also had similar statutes and both were amended or repealed to remove the limitation to in-state transactions only.

This bill would take effect immediately as a tax levy and specifies that it would be operative for tax years beginning on or after January 1, 2011, and before January 1, 2012.

B. Fiscal Analysis

The FTB estimates the two provisions of this bill would have a net revenue neutral impact on the General Fund and would not impact FTB's costs. Separately, the provisions would have the following revenue impacts:

1) California New Markets Tax Credit Program: revenue losses of $2.5 million in 2010-11, $3.9 million in 2011-12, and $600,000 in 2012-13.

2) Elimination of like-kind exchange treatment: Revenue gains offsetting the above tax credit program of $2.5 million in 2010-11, $3.9 million in 2011-12, and $600,000 in 2012-13.

Code/Department Agency or Revenue Type	SO LA CO RV	PROP 98	FC	2010-2011	FC	2011-2012	FC	2012-2013	Fund Code
			(Fiscal Impact by Fiscal Year) (Dollars in Thousands)						
1147/Pers Inc Tax	RV	No		------------------- No/Minor Fiscal Impact -------------------					0001
1730/FTB	SO	No		------------------- No/Minor Fiscal Impact -------------------					0001