

Date of Hearing: April 9, 2013

ASSEMBLY COMMITTEE ON JOBS, ECONOMIC DEVELOPMENT AND THE
ECONOMY

Jose Medina, Chair

AB 305 (V. Manuel Pérez) – As Introduced: February 12, 2013

SUBJECT: Income taxes: hiring credits: investment credits

SUMMARY: Creates a \$200 million state New Markets Tax Credit (NMTC) Program for the purpose of stimulating economic development and hasten California's economic recovery. In general, the new state credit parallels the federal NMTC. Specifically, this bill:

- 1) Authorizes the creation of the NMTC Program, administered through the California Tax Credit Allocation Committee (TCAC), for the purpose of allocating tax credits in tax years 2013 through 2019 to a qualified community development entity (CDE).
- 2) Authorizes TCAC to allocate up to \$30 million in tax credits annually to qualified CDEs for a total allocation of \$200 million. As a condition of receiving the credits, CDEs must annually report to TCAC on the use and impact of the credits. Unused credits are to be returned for reallocation.
- 3) Authorizes a qualified CDE to re-award these credits to private investors who make qualified equity investment in the CDE. Moneys received from these investments are to be used to make qualified low-income community investments, which may include loans and capital investments in businesses (including start-ups), real estate and other qualified CDEs that undertake development projects in eligible low-income areas.
- 4) Authorizes the 39% credit, spread over seven years, to be applied against the tax payer's personal and corporate tax liability. There would be no credit allowance in the first two years, 7% for the third year; and 8% for each of the final four years. The bill provides for the recapture of the value of the credit if the investment is withdrawn from the CDE prior to the close of the seventh year, as specified.
- 5) Defines a qualified equity investment to mean an equity investment of cash made by the tax payer to the qualified CDE. This cash must be substantially used by the CDE to make qualified low-income community investments within five years of the CDE receiving the credit allocation from TCAC.
- 6) Defines a qualified low income community to mean a census tract where any of the following applies:
 - a) The tract has a poverty rate of at least 20%.
 - b) The tract is not located within a metropolitan area, and the median family income does not exceed 80% of the greater statewide median income.
 - c) The tract is located in a metropolitan median area, and the median family income does not exceed 80% of the greater of the statewide or metropolitan median family income.

The bill also authorizes the use of census block group data from the American Community Survey once the U.S. Census Bureau discontinues using the decennial census to report median family income on a census tract basis.

- 7) Defines qualified low-income community investments to mean:
 - a) Any capital or equity investment in, or loan to a qualified low-income business, as defined;
 - b) Any capital or equity investment in, or a loan to, a real estate project in a low-income community;
 - c) The purchase of a loan from another CDE that meets the other requirements for a low-income community investment;
 - d) Financial counseling and other services in support of business activities to businesses and residents of a low-income community; or
 - e) Any equity investment in, or a loan to, a CDE.
- 8) Defines a qualified CDE as a domestic corporation or partnership that has a primary mission of serving or providing investment capital for low-income communities or low-income persons; has low-income residents on its governing or advisory board; and is certified by the TCAC. A CDE also includes any entity that has an allocation agreement with the federal Community Development Financial Institution Fund (CDFI Fund).
- 9) Excludes Small Business Investment Companies and Community Development Financial Institutions from being an eligible CDE under the state program, although they are considered CDEs for the purposes of the federal program.
- 10) Defines an equity investment as any stock, other than nonqualified preferred stock, in a corporation or any capital interest in any partnership.
- 11) Requires TCAC to establish guidelines for implementing the NMTC program and set fees to cover the costs for administering the program. These guidelines will include the allocation process, which, among other things, is required to create an equitable distribution of the credits including a 15% reserve for environmental justice communities, 15% agriculture-related businesses, and 20% for inner city businesses.
- 12) Appropriates \$150,000 from Tax Credit Allocation Fee Account to the TCAC for the purpose of administering the new tax credit program. These moneys are only available for expenditure until January 1, 2020 and it is the Legislature's intent that these moneys would be reimbursed through fees on the New Market Tax Credit application.
- 13) Reduces the cumulative total of the use of Small Business Hire Credit (SBHC) from \$400 million to \$100 million. Once the Franchise Tax Board (FTB) estimates that it has received original tax returns claiming credits that total \$100 million, no additional credits may be claimed following the end of that calendar year quarter.
- 14) Takes immediate effect as a tax levy.

EXISTING LAW STATE LAW:

- 1) Authorizes a qualified tax payer, on their personal or corporate tax return, to claim a \$3,000 credit against state tax liability for each net increase in full-time employees hired during the taxable year. Credits must be claimed on an original return and be filed prior to FTB estimating it has received returns claiming \$400 million in credits, as defined. Qualified tax payers are limited to businesses with fewer than 20 employees as of the last day of the preceding taxable year.
- 2) Authorizes a taxpayer to claim a state credit equal to 20% of qualified investments in community development financial institutions. The credit may be used against the tax payers' personal income tax, corporation tax, and insurance premiums tax for non-interest bearing investments of at least \$50,000, which are held for a minimum of 60 months. Total qualified investment for all tax payers are capped at \$10 million per year (\$2 million in credits).

EXISTING FEDERAL LAW authorizes a tax payer to claim a federal tax credit for qualified investments made to qualified CDEs, as specified. The value of the federal NMTC is 39% of the qualified equity investment. The credit is applied by the tax payer over a seven-year period.

FISCAL EFFECT: Unknown

COMMENTS:

- 1) Author Purpose: According to the author, "California can no longer afford to leave millions in federal money on the table, year after year, by failing to implement a state New Markets Tax Credit Program to jump-start economic productivity in our low-income areas. Such a program will enable us to leverage many times more in federal funds than it would cost the state to implement, and lead directly to capital investment in small businesses, a proven model for helping to end an economic recession. At least nine other states have successfully implemented such a program already, on average leveraging 13 times more in federal monies than they allocated in planned revenue to fund the tax credit. This bill means community empowerment because the program in question has a proven track record of job creation."
- 2) Framing the Policy Issue: This measure proposes the establishment of a new state tax credit to help spur investments in low-income neighborhoods. Funding for the new credit is provided through the phasing-out of an underperforming small business tax credit.

While there have been several attempts to improve and expand the existing credit, Members may want to consider whether using tax credits to serve the access to capital needs of small businesses is the best method to provide support. Many small size businesses have few taxable revenues making tax credits of limited assistance. AB 305 takes an alternative approach for assisting these same small size businesses in low-income neighborhoods. This bill provides a proven mechanism for locally-based CDEs to provide loans, equity investments, and financial counseling. In addition, CDEs can investment in real estate and other projects that benefit local businesses and residents.

The analysis includes a discussion of how the NMTC may address the state's increasing income disparities, challenges businesses face in accessing capital, background on the federal NMTC program, and examples of NMTC programs in other states.

- 3) Economic Justice: Research shows that the inequality between the residents in low-income communities and those that reside in California's most affluent communities has dramatically increased in the past several decades. For example, the average inflation-adjusted income of the top 1% of California's taxpayers increased by 50.2% between 1987 and 2009, from \$778,000 to \$1.2 million. In contrast, the average income of taxpayers in each of the bottom four-fifths of the distribution lost purchasing power. This economic disparity has significant social and economic ramifications for everyone in the state and directly challenges the state's global competitiveness and long-term economic success.

Programs like the NMTC program proposed in this measure are based on the economic principle that targeting significant incentives to lower income communities allows these communities to more effectively compete for new businesses and retain existing businesses, which results in increased tax revenues, less reliance on social services, and lower public safety costs. Residents and businesses also directly benefit from these more sustainable economic conditions through improved neighborhoods, business expansion, and job creation.

- 4) Challenges to Accessing Capital: Access to debt and equity financing is critical for promoting the efficient operation and expansion of small businesses. Small businesses rely on adequate short-term (working capital) and long-term debt as well as equity financing to purchase new equipment, replenish inventories, fund ongoing operations, and market their services long before those activities generate revenue. While financial institutions routinely extend working capital and long-term debt products to established, larger businesses, smaller businesses are often bypassed because they lack the collateral and threshold operating and revenue generating history of larger businesses.

The same dynamic occurs when small businesses attempt to access equity financing, with investment funds often bypassing smaller businesses because they lack the operating history and revenue generating track record of larger businesses. The situation often results in a "chicken and egg" scenario whereby businesses are told they need to grow in order to access financing, while at the same time being denied access to the financing they need to grow.

It should be noted that in the aftermath of the recession, many banks moved to tighten lending standards. In fact, according to the U.S. Chamber of Commerce, a record 74.5% of banks reported raising lending standards in the fourth quarter of 2008. While it is unclear if banks have since moved to further tighten lending standards, what is clear is that banks are not yet comfortable lowering their standards to increase liquidity to small businesses, making it difficult for small businesses to flourish and grow. AB 305 would support the development of new capital resources for businesses in low-income neighborhoods.

- 5) Federal New Market Tax Credit Program: Congress enacted the NMTC with the Community Renewal Tax Relief Act of 2000 for the purpose of stimulating equity investments in low-income communities. Under the program, CDE's apply to the U.S. Treasury's CDFI Fund, for an allocation of federal tax credits, which the CDE can then offer to individual and corporate investors in exchange for making an equity investment in the CDE or its subsidiary.

In this way, the CDE serves as a community and financial intermediary between sources of private capital and low-income communities. The value of the federal credit to the investor

is 39% of the original investment amount, claimed over a period of seven years (5% for each of the first three years, and 6% for each of the remaining four years). The investment in the CDE cannot be redeemed before the end of the seven-year period.

On January 3, 2013, President Obama signed the American Taxpayer Relief Act of 2012 which included an extension of the New Markets Tax Credit Program for 2012 and 2013. The tax credit allocation authority is \$3.5 billion for each year. Since its inception, The CDFI Fund has made 664 awards allocating a total of \$33 billion in NMTC authority to CDEs through its competitive application process. This \$33 billion includes \$3 billion in Recovery Act Awards and \$1 billion of special allocation authority to be used for the recovery and redevelopment of the Gulf Opportunity Zone.

Supporters of the bill have expressed concern that California has not received its fair share of federal NMTC allocations. States that regularly receive larger shares have parallel state tax credit programs or other resources that encourage the community development within lower income communities. In 2012, 29 California CDEs received federal NMTC allocations totaling \$17 million. Individual allocations range from \$1.4 million for Northern California Community Loan Fund to \$100,000 to the Women's Economic Ventures of Santa Barbara.

6) Other State New Market Tax Credits: Since the inception of federal NMTC, at least nine other states have enacted matching programs to help leverage more federal dollars in NMTC investments including: Ohio, Florida, Missouri, Louisiana, Mississippi, Kentucky, Illinois, Oklahoma, and Connecticut. According to information provided by the author's office, several of these states have experienced a return on investment of 13 to 1. In addition, the author states:

- In Missouri, in the first two years the state New Markets Tax Credit paid for itself, bringing in more in additional investment dollars that was allocated in state funds for the entire seven-year period.
- In Illinois, federal allocations of NMTC funds more than doubled after the Legislature implemented a matching state program in 2008. In the first year of implementation, allocations jumped to \$875 million. Prior to the 2008 law, federal allocations never exceeded \$400 million.

7) NMTC Research Findings: In 2010, the General Accounting Office released a report on the New Market Tax Credit program that found:

- a) Since 2003, NMTC investments totaling \$26 billion have been made in all 50 states, the District of Columbia and Puerto Rico.
- b) NMTC investments in low-income community businesses generally use leveraged structures, where equity is left in the businesses, or subsidized loan structures, where below market interest rate loans are offered.
- c) At the time of the report, the CDFI Fund did not collect data that could identify the portion of the subsidy channeled to businesses, such as data on credit pricing, transaction fees, and the amount of equity left in the businesses.

According to a January 2011 case study prepared by Pacific Community Ventures on the NMTC program, *Impact Investing: A Framework for Policy Design and Analysis*:

- Through 2009, CDEs made more than \$16 billion in NMTC investments in low income communities.
 - Approximately 95% of NMTC funds are invested in designated areas of distress, and 90% in metropolitan areas.
 - For every dollar of forgone tax revenue, NMTC leverages \$12-\$14 of private investment.
- 8) Possible Amendments - Technical and Substantive: The author has used the federal NMTC program as a model for this bill and for the purposes of tax simplification, it is important that definitions remain consistent. There are, however, several technical and substantive issues that the committee may want to address:
- a) CDFIs and SBICs: AB 305 excludes CDFIs and SBICs from participating on the state NMTC Program unless the entity has received a federal NMTC allocation. These entities are important financial and community development intermediaries within low-income communities and should perhaps be allowed to become certified and participate in the state program. The author may have excluded CDFI because they are eligible to receive state CDFI tax credits. As long as the basis of the tax credit isn't counted for both credits there should be no problem in double dipping.
 - b) Remaining Small Business Credit: AB 305 reduces the size of the Small Business Hire credit to \$100 million. As of March 2013, over \$142 million has been applied. The author may want to allow for up to \$175 million in credits to be applied before shutting down the credit.
 - c) Major Community Development Projects: The state NMTC Program will provide new community development moneys to low income communities. In order to ensure these moneys provide the greatest leveraging, it may be useful to protect the ability to use a range of incentives on a single project, as long as no single segment of the financing is counted twice for the purposes of a tax incentive. For large scale projects it is not uncommon that multiple funding sources and incentives are needed.
 - d) Define Start-up Business: AB 305 specifically includes financing and assistance to start-up businesses. A question arises as to what is a start-up business. Since many traditional financial institutions require businesses to have not less than a five-year track record before providing a loan, it may serve as a useful dividing point.
- 9) The Existing Small Business Hiring Credit Program: Implementation of this bill will reduce the authorized credits under the SBHC program and use the amount of the reduction to fund the credits authorized in the NMTC program. Concerns have previously been raised, including by the Governor during his 2013 State of the State speech, that the SBHC Program was a poor performing tax credit. According to the Franchise Tax Board, 24,345 personal income tax and business entity returns had been filed (March 2013) using the SBHC Program with a cumulative credit value of \$142.4 million.
- 10) Related Legislation: Below is a list of related legislation:

- a) AB 32 (John A. Pérez) Expansion of the CDFI Credits: This bill increases the aggregate amount of CDFI tax credits that may be annually allocated from \$10 million to \$20 million under the Insurance Gross Premiums Tax, Personal Income Tax and Corporation Tax Laws, as provided. Status: Pending in the Assembly Committee on Revenue and Taxation's Suspense File.
 - b) AB 643 (Davis and V. Manuel Pérez) State New Market Tax Credit: This bill would have enacted a New Markets Tax Credit for qualified investments made in low income communities in the 2012 calendar year. The State Treasurer's Office would administer the new credit program and allocate credits in an amount equal to \$300 million over six years. Status: Held in the Assembly Committee on Appropriations in 2012.
 - c) AB 624 (John A. Pérez) California Organized Investment Network: This bill extended the operation of the Community Development Financial Institution Investments tax credit until January 1, 2017, and requires the Insurance Commissioner to establish a California Organized Investment Network Advisory Board, as specified, to advise the California Organized Investment Network on the best methods of increasing insurance investments while providing fair returns to investors and social benefits to underserved communities. Status: Signed by the Governor, Chapter 436, Statutes of 2011.
 - d) SB 1316 (Romero) State New Market Tax Credit: This bill would have enacted a New Markets Tax Credit for qualified investments made in low income communities in the 2011 calendar year. The State Treasurer's Office would administer the new credit program and allocate credits in an amount equal to the estimated revenue gains resulting from the temporary elimination of specified like-kind property exchanges. Status: Died on the Senate inactive file in 2010.
- 11) Double Referral: This measure was referred to two policy committees by the Assembly Committee on Rules. Should AB 305 pass the Assembly Committee on Jobs, Economic Development and the Economy, the bill will be referred to the Assembly Committee on Revenue and Taxation for further action.

REGISTERED SUPPORT / OPPOSITION:

Support

TELACU (sponsor)
California League of Cities
California Bankers Association

Opposition

None received

Analysis Prepared by: Toni Symonds / J., E.D. & E. / (916) 319-2090