Date of Hearing: January 10, 2012

ASSEMBLY COMMITTEE ON JOBS, ECONOMIC DEVELOPMENT AND THE ECONOMY
V. Manuel Pérez, Chair
AB 643 (Davis) – As Amended: January 4, 2012

SUBJECT: State New Market Tax Credit

SUMMARY: Creates a $300 million state New Markets Tax Credit program (NMTC) for the purpose of stimulating economic development and hasten California's economic recovery. Specifically, this bill:

1) Authorizes the creation of the California New Markets Tax Credit Program, administered through the California Tax Credit Allocation Committee (TCAC), for the purpose of allocating tax credits to qualifying community development entities (CDE).

2) Authorizes a CDE to award tax credits to private investors who make qualifying equity investments in the CDE. Moneys received from the investments are to be used to make qualified low-income community investments, which may include, among other things, loans and capital investments in businesses, real estate and other CDEs that undertake development projects in eligible low-income areas.

3) Authorizes a tax credit valued at 39% of a tax payer's qualified equity investment in a CDE, beginning in 2013 and ending in 2019. The credit may be applied against the tax payer's personal and corporate tax liability. The bill provides for the recapture of the value of the credit if the investment is withdrawn from the CDE prior to the close of the seventh year, as specified.

4) Defines a qualifying equity investment to mean an equity investment made to a CDE that makes qualifying investments in California low-income communities, as defined.

5) Defines a 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 the greater of the statewide or metropolitan median family income.
   d) The tract is located within a high migration rural county, and the median family income does not exceed 85% of the statewide median income. A "high migration" area is defined as a county that has experienced (for the last two decade census reporting periods) net outmigration of inhabitants of at least 10%.
   e) When a community is in a location that has not been tracted by the US Census Bureau, the equivalent county divisions shall be used for determining poverty rates and median family income.
   f) Where a community has a census tract of under 2,000 people, that the community is to be treated as a low-income community if the tract is within a federal empowerment zone and is contiguous to one or more low-income communities, as defined.

6) 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.

7) Defines a 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).

8) Defines an equity investment as any stock, other than nonqualified preferred stock, in a corporation or any capital interest in any partnership.

9) Requires TCAC to establish guidelines for implementing the NMTC program and set fees to cover the costs for administering the program. Up to $50 million in tax credits may be allocated in any one tax year for a total allocation of $300 million over the six years of the NMTC program. Priority is to be given to CDEs that:

   a) Have a record of successfully providing capital and technical assistance to disadvantaged business or communities; or
   b) Intend to make qualified low-income community investments in one or more business in which person unrelated to the CDE hold a majority interest.

10) Appropriates $150,000 from Tax Credit Allocation Fee Account to the California Tax Credit Allocation Committee 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.

11) 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 is has received original tax returns claiming credits that total $100 million, no additional credits may be claimed.

12) Takes immediate effect as a tax levy.

<u>EXISTING LAW STATE LAW</u>:

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 LAW FEDERAL LAW authorizes a tax payer to claim a credit on their federal tax return for qualified investments made to CDEs. The value of the federal NMTC is 39% of the value of the qualified investment taken over a seven year period.

FISCAL EFFECT: Unknown

COMMENTS:

1) **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) **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 two 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.

3) **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 revolvers 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 Great Recession, many banks moved to tighten lending standards. In fact, according to the US 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 643 would support the development of new capital resources for businesses in low-income neighborhoods.

4) **Federal New Market Tax Credit Program**: Congress enacted the NMTC with the Community Renewal Tax Relief Act of 2000 (Public Law 106-554) for the purpose of stimulating equity investments in low-income communities. Under the program, CDE's apply to the US 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.

   The CDFI Fund has made 594 awards allocating a total of $29.5 billion in tax credit authority to CDEs through its competitive application process. This $29.5 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.

5) **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.

6) **Other states use variety of access to capital strategies**: In addition to NMTCs, several states have recently created or will soon create venture funds to support local entrepreneurs, including targeting resources to historically underserved areas. Among other sources of funding, more than one dozen states have used their share of the federal Small Business Credit Initiative to capitalize venture funds including Arkansas, Florida, Hawaii, Indiana, Iowa, Kansas, Louisiana, Maine, Maryland, Missouri, Nebraska, New Hampshire, New Jersey, New York, Ohio, Oklahoma, Puerto Rico, Rhode Island, Tennessee, Texas, Washington, West Virginia and Wisconsin.

   Washington State used its $19.6 million in federal Small Business Credit Initiative moneys to fund direct and guarantee programs, as well as capitalizing a venture fund. The $5 million in federal money allocated for the venture fund has already attracted another $20 million in private investor capital. The Washington Department of Commerce anticipates that for every $1 the state invests, approximately $15 to $18 will be generated in private lending or investment, potentially injecting $300 million into the state economy and generating 3,000 to 6,000 direct and indirect jobs.

   While historically California has been a national leader in start-ups and venture capital, the state's slow recovery from the recession and the increasing competition from other states, as illustrated by the creation of these state NMTC programs and venture funds, could threaten California's position. This is especially true for states like Washington and Texas that have been actively pursuing California businesses with marketing strategies that emphasize a better business climate and government support for the business community.

   These new business incentives also represent potentially new competition for venture capital from states that do not traditionally receive much of this type of capital. Nebraska, as an example, is not just adding a venture fund, but it is also considering a new tax credit for angel investors. These types of new capital incentives would, no doubt, make second tier investment states such as Nebraska a much more attractive investment location.

7) **Extension of Federal Credit**: The federal NMTC is set to expire in 2011. The US Congress is currently considering legislation to extend the federal NMTC program through 2016. Identical measures have been introduced in the House (H.R. 2655 by Rep. Jim Gerlach of Pennsylvania) and Senate (S.996 by Senator John D. Rockefeller) and make no substantive changes to the program. Currently (January 7, 2011) H.R. 2655 is before the Committee on Ways and Means, and S.996 is before the Committee on Finance.

8) **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.

9) **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) *Definition of a qualifying low-income neighborhood*: Starting with the 2010 Census, the US Census Bureau will no longer be reporting median family income through the decennial census by census tracts and will instead be using a one-to-five year snapshot of household income determined by the American Community Survey and reported by census block groups. It may be prudent to anticipate the federal change and allow for the more current household income reporting.

b) *Reporting*: The committee may wish to provide greater accountability and transparency to the NMTC program by requiring that CDEs to report on the types of investments made and the impact of the credits on low-income communities. In addition, TCAC should be monitoring and annually reporting on geographic allocation of the credits and have some level of outreach responsibility. Reporting, if required, should also be consistent with other community and business development programs.

c) *Minimum CDE Capacity Standards and Roll-Over Provisions*: AB 643 proposes to prioritize tax credit allocations to CDEs that have solid track records and those that commit to investing in qualified businesses in low-income communities. The committee may require that TCAC set minimum CDE capacity criteria to ensure that the CDE receiving the allocation has a demonstrated capacity to successfully convert the credits into low-income community investments. Further, in the event that a CDE is unable to fully utilize its NMTC allocation, it may be appropriate to have a process whereby the credits are returned for reallocation.

d) *Roll-Over of Tax Credit Allocation*: The bill currently sets a maximum of credits that may be allocated in any given year. It may be useful to allow for roll over of credits in order to fully leverage the $300 million.

e) *Business Start-Ups*: The bill currently includes a definition of a "qualified active low-income community business," which could be interpreted as limiting business financial and technical assistance to existing business. With small size early stage businesses historically providing the greatest job growth, according to a recent study by the Kaufman Foundation, the author may want to clarify this issue with a technical amendment.

10) **Impact on the existing Small Business Hiring Credit Program**: Implementation of this bill will reduce the authorized credits under the SBHC and use the amount of the reduction to fund the credits authorized in the NMTC program. According to the FTB and information provided by the Assembly Committee on Revenue and Taxation, 12,903 personal income tax and business entity returns had been filed as of December 2011using the SBHC with a cumulative credits value of only $76 million.

Concerns have previously been raised, including within the Governor's 2011-12 May Revision Report, that the SBHC was being significantly underutilized. While there have been several attempts to improve and expand the SBHC (as described below), Members may want to consider whether a tax credit to a very small size business is the best way to provide support. Many small size businesses have so few taxable revenues that tax credits are of limited assistance. AB 643 takes an alternative approach for assisting these same size businesses by providing a credit to the tax payer who provides the cash to the CDE, which then uses those funds to make direct loans and equity investments to small businesses in low-income communities.

11) **Related Legislation**: Below is a list of related legislation:

a) AB 234 (Wieckowski) - Small Business Tax Credit: This bill modifies and expands the existing new hire credit for businesses with less than 20 employees. Among other changes, the bill expands the credit to include disabled and disadvantaged businesses, as well as increasing the $3,000 value of the credit by establishing a two-tier credit based on whether the new full-time employee earns under or over $16 an hour - $4,500 credit v. $9,100 credit. Status: Scheduled to be heard in the Assembly Revenue and Taxation Committee on Monday, January 9, 2012.

b) AB 624 (John A. Pérez) - California Organized Investment Network: This bill extends 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.

c) 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: The bill died on the Senate inactive file, 2010.

REGISTERED SUPPORT / OPPOSITION:

Support

Advantage Capital Partners
Greater Sacramento Urban League
National Urban League
Novogradac
Stonehenge Capital Company
TELACU

One letter of support from an individual

Opposition

None received

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