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ALERT

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California Business Tax Incentive Legislation

California has completely overhauled its tax-related economic incentive laws by repealing nearly all existing incentives, and replacing them with a new sales tax benefit and limited income tax incentives, primarily for the manufacturing sector and for certain other businesses located in enterprise zones and other high-unemployment or high-poverty areas. In addition, the governor's office will have discretion to grant additional tax credits to other businesses; however, several of these new incentive provisions will require additional clarification.

Over the past 20 or so years, the legislature and various Governors enacted many tax incentives designed to stimulate employment or business growth in certain economically disadvantaged areas of the state, each of which was subject to numerous limitations, special definitions, and exceptions.[1] These include:

- an income tax credit for sales and use tax paid on purchases of certain types of machinery and equipment used within targeted tax areas as defined (Sections 17053.33, 23633) ;[2]
- an income tax credit for wages paid to newly hired employees by businesses in target areas if the new hires were unemployed, or members of the military, or qualified as low income under certain tests (17053.34, 23634);
- an income tax credit for sales or use tax paid on purchases of certain equipment for use in a local agency military base recovery area (LAMBRA), as defined, which leads to an increase in employment (17053.4, 23645);
- an income tax credit for hiring certain disadvantaged individuals or displaced employees for employment within a LAMBRA (17053.46,23646-);

[1] In the interest of economy, this *Alert* does not detail the many specific rules applicable to each incentive measure listed in the appended text paragraph. For details, please consult your GT attorney or the individuals listed at the end of this *Alert*.
[2] Section references are to the California Revenue and Taxation Code unless otherwise indicated.

- an income tax credit for a portion of the wages paid to employees in designated "manufacturing enhancement areas" (17053.47, 23622.8);
- an income tax credit for sales and use tax paid on purchases of certain machinery and equipment for use in enterprise zones (17053, 23612.2);
- an income tax credit for certain wages paid to employees of businesses in enterprise zones for five years after hire (17053.74, 23622.7);
- an income tax credit allowed to employees of certain enterprise zone businesses for a portion of the wages received by the employees (17053.75);
- a deduction for net interest received with respect to loans to persons or entities engaged in enterprise zone businesses (17235, 24384.5);
- a deduction for up to 40 percent of the cost of property purchased for use in a business located in an enterprise zone, "targeted tax area" or LAMBRA, subject to certain caps on cost that diminish over time (17267.2; 17267.6, 17268, 24356.6, 24356.7, 24356.8);
- allowance of net operating loss carrybacks for trades or businesses located in enterprise zones, LAMBRAS, and targeted tax areas for up to 15 years without regard to various suspensions (17276.2 17276.5, 17276.6, 24416.2, 24416.5, 24416.6); and
- a limited credit for net increases in employment by small businesses not eligible for the other employment-related credits (17053.80, 23623).

Statutes enacted at the end of the 2013 regular legislative session have repealed all of these, effective for taxable years beginning on or after January 1, 2014, except for allowance of carryovers of credits and losses generated before that date. (AB 93, Stats. 2013, c. 69; SB 80, Stats. 2013, c. 70). This action was taken following a strong lobbying effort by Governor Brown, who viewed the enterprise zone and related incentives as having failed to achieve their desired purposes.

In place of the repealed measures, and effective for taxable years beginning in 2014 and thereafter until specified sunset dates, the 2013 legislation provides for three specified tax incentives, one in the Sales and Use Tax Law, and two in both the Personal Income Tax Law and Corporation Tax Law. These are briefly described below; however, there are numerous uncertainties in the statutory language that await clarification in either future legislation or regulations issued by the Franchise Tax Board or State Board of Equalization.

Sales Tax Exemption. Under new Section 6377.1 of the Revenue and Taxation Code, qualified taxpayers engaged in manufacturing and similar physical processing activities (including processing, refining, fabricating, or recycling, but not extraction), or research and development may purchase machinery, related equipment used to operate, control, regulate or maintain machinery, pollution control equipment, and certain special purpose buildings used as an integral part of a manufacturing or production process, free from sales tax. The section is effective for qualified property purchased or used beginning July 1, 2014, and before July 1, 2022. A qualified taxpayer must be a person primarily engaged in activities described in Codes 3111 to 3399 inclusive of the North American Industry Classification System, 2012 edition, relating to manufacturing, or 541711 or 541712 of the NAICS, relating to research and development. However, taxpayers engaged primarily in extraction of natural resources, or production of agricultural commodities at the growing stage, are not qualified taxpayers. A taxpayer (or group of commonly owned or controlled taxpayers) is limited to $200 million of purchases of qualified tangible personal property. Certain rental payments for leases of qualified machinery and equipment will also be eligible for sales tax relief. The exemption does not apply to local sales and use

taxes imposed by counties, cities, and other governmental bodies, or to the portion of the state rate that is dedicated to local government support.

Limited Credit for Wages Paid in Enterprise Zones and Other Targeted Areas. Enterprise zone and similar benefits have been preserved, to a limited extent, through the enactment of a new state income tax credit available to many individuals and corporations (17053.73, 23626) that are “qualified taxpayers” for certain wages paid to certain employees (“qualified full-time employees”) for work in certain qualifying areas known as “designated census tracts or economic development areas.” The credit can be up to 35 percent of the portion of wages paid to qualified employees, as defined, that exceeds 150 percent of minimum wages (currently $8.00 per hour, so that the 150 percent floor is $12 per hour) but does not exceed 350 percent of minimum wage (so that the ceiling is $28 per hour) paid to qualified employees for five years following the date of employment. However, the credit is limited to a percentage of otherwise qualifying wages approximating the percentage increase in the number of full time employees in California during the year compared to the number of full time employees in the base year, which is 2013 for most taxpayers, but for businesses who first hire qualified employees in taxable years beginning after 2014, the base year is the taxable year immediately preceding the year of first such hire.

Three other critical terms used in this credit provision are “qualified full-time employee,” “qualified taxpayer” and “designated census tract or economic development area.”

A “qualified full time employee” must perform at least 50 percent of his or her services in a designated census tract or economic development area; must receive starting wages that are at least 150 percent of minimum wage, or at least $12 per hour currently, must be hired on or after January 1, 2014, and after the Department of Finance makes a determination regarding the qualification of the geographic area in which he or she will primarily perform his duties, must be paid qualified wages for an average of at least 35 hours per week, or be a salaried employee considered to receive compensation for full time employment within the meaning of Section 515 of the Labor Code, and he or she must satisfy at least one of the following five conditions:

- (i) Was unemployed for six months preceding employment with the qualified taxpayer (and must have completed any college or graduate level studies at least one-to-two months before commencement of employment); or
- (ii) Is a veteran separated from the Armed Forces of the United States no more than 12 months before the commencement of employment; or
- (iii) Was entitled to the federal earned income credit in the previous taxable year; or
- (iv) Is an ex-offender previously convicted of a felony (apparently, no time limit applies to this category); or
- (v) Is a recipient of benefit under the CALWORKS program or general assistance under specified programs set out in the Welfare and Institutions Code.

Unlike the prior provisions regarding enterprise zones, the new legislation does not require obtaining of an eligibility voucher for a new hire from the state or local agency administering the particular enterprise zone, but it remains to be seen whether employers will be required to make their own determinations of eligibility or will be required to obtain some form of certification.

Qualified taxpayers generally include most businesses, not limited to manufacturing, but exclude temporary help services, most retail trade establishments, most food services establishments, gambling centers, and sexually oriented businesses (which are defined in exquisite detail, including a related definition of “nude”). Small businesses (those with gross receipts of less than $2 million in the previous taxable year, taking into account activities of related entities) are, however, exempt from the foregoing limits, except the one on sexually oriented businesses. Again with the exception of small businesses, qualified taxpayers that relocate to a designated census tract or economic development area must provide each employee at the previous location or locations a written offer of employment at the new location with comparable compensation.

A designated census tract is a census tract within California that is determined by the Department of Finance to have a civilian unemployment rate within the top 25 percent of all census tracts in the state, and a poverty rate within the top 25 percent of all such census tracts. An economic development area means an enterprise zone that had been designated pursuant to legislation through June 30, 2013, but excluding census tracts within any such zone that is identified by the Department of Finance as being in the lowest quartile of census tracts with regard to civilian unemployment and poverty, or a LAMBRA designated pursuant to the now-repealed legislation in the Government Code.

An example illustrating the computation of the credit is as follows. In 2015, a qualified employer has 150 full-time employees in California (both qualified and non-qualified), while in 2013 it had 120 such employees. During 2015, it has 40 qualified full-time employees. At the beginning of 2015, it hires John Smith, a qualified full-time employee, and pays him compensation for 2000 hours of work at a rate of $12 per hour. The wage credit earned by these facts is computed as follows:

> .35* H * (AW-MW) *(FTEC – FTEB)/QFTEC,
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> where H is the number of hours of work paid (2,000), AW is the average wage paid ($12), MW is the minimum wage ($8), FTEC is the number of full time employees in the state in 2015; FTEB is the number of full time employees in the state in the base year of 2013, and QFTEC is the total number of qualified full-time employees in the state during 2015. Substituting these values for the variables gives:
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> .35*2000*($12-$8)*(150-120)/40, or 700*$4*30/40, or $2100.

If the total allowable credits exceed the net tax (reduced by certain other allowable credits) they can be carried forward for up to 4 years until they are exhausted.

To qualify for the wage credit, the employer must apply for a tentative credit reservation from the FTB, within 30 days after it complies with the EDD’s new hire reporting requirements, in a form and manner to be prescribed by the FTB, and annually certify that the qualified full-time employee for which a credit was granted is still employed. The application must include the name, social security number of the employee, the start date of employment, the rate of pay of the employee, the qualified taxpayer’s gross receipts for the previous taxable year. The FTB will presumably devise a form to be used in order to obtain the credit reservation. Interestingly, for years in which credits may be granted, the FTB is required to post on its website information including employer names, amount of credit claimed, and number of new jobs created.

Credits will have to be paid back to the state (recaptured) if an employee from whom a credit was claimed is terminated by the employer within the first 36 months after commencing employment, with certain exceptions relating to voluntarily departures, disability, misconduct, substantial reduction in the operations of the taxpayer, replacement by other employees which result in a net increase in number of employees and hours of employment, and termination relating to seasonal businesses where the employee is later rehired for the next season.

Administrative Issuance of Additional Credits for Employment. In provisions loosely modeled on the film tax credit legislation enacted in 2009, the Legislature has also provided that an aggregate of up to $750 million per year of credits, less the amounts as estimated by the Director of Finance that will be claimed pursuant to the other provisions of the bill, may be awarded by the Governor's Office of Business Development (referred to as "GO-Biz" in the legislation), subject to approval from the newly created California Competes Tax Credit Committee.[3] (The allocation for the administrative credit is limited to $30 million in the 2013-14 fiscal year, $150 million in the 2014-15 fiscal year and $200 million in the 2015-16 through 2017-18 fiscal years). The allocation is to be based on an evaluation of 11 factors, set out in the statute as follows:

(A) The number of jobs the taxpayer will create or retain in this state.

(B) The compensation paid or proposed to be paid by the taxpayer to its employees, including wages and fringe benefits.

(C) The amount of investment in this state by the taxpayer.

(D) The extent of unemployment or poverty in the area according to the United States Census in which the taxpayer's project or business is proposed or located.

(E) The incentives available to the taxpayer in the state, including incentives from the state, local government and other entities.

(F) The incentives available to the taxpayer in other states.

(G) The duration of the proposed project and the duration the taxpayer commits to remain in this state.

(H) The overall economic impact in this state of the taxpayer's project or business.

(I) The strategic importance of the taxpayer's project or business to the state, region, or locality.

(J) The opportunity for future growth and expansion in this state by the taxpayer's business.

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[3] The Committee consists of the State Treasurer, an elected official, and the Director of Finance and Director of GO-Biz, both of whom are gubernatorial appointees. Whether this committee will be an effective monitor of another Governor's office remains to be seen.

(K) The extent to which the anticipated benefit to the state exceeds the projected benefit to the taxpayer from the tax credit.

Go-Biz is directed to give priority to taxpayers whose project or business is to be located in an area of high unemployment or poverty, and may not allocate a credit unless a written agreement between it and the taxpayer is executed and approved by the Tax Credit Committee. Apart from the criteria and the foregoing exhortation, and in stark contrast to the excruciating detail of many other current and former statutory provisions in the nature of economic incentives, GO-Biz apparently has broad discretion in terms of the amount of credits, and the basis on which they are awarded.

The names of taxpayers awarded credits, the estimated investment and jobs to be created, and the amount of credit allocated or recaptured in the event of a contract breach by the taxpayer, are all to be made publicly available. The Franchise Tax Board is directed to audit all taxpayers claiming credits except that it has discretion to review returns of small businesses.

At least 25% of the credits authorized by this provision must be reserved for small businesses, as defined above, and no more than 20 percent of the maximum allowable credit may be allocated to any one taxpayer.

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