Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Frommer	Analyst:	Darrine Distefano	Bill Number:	AB 1601
Related Bills:	See Legislative History	Telephone:	845-6458	Introduced Date:	02-21-2003
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Employer Qualified Wages Credit

SUMMARY

This bill would allow a wage credit to employers.

PURPOSE OF THE BILL

According to the author's staff, this is a spot bill and will be amended to address abusive tax shelters.

EFFECTIVE/OPERATIVE DATE

This bill would be effective immediately upon signature and specifically operative for taxable years beginning on or after January 1, 2004 and before January 1, 2014.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Existing state and federal laws allow a taxpayer to deduct expenses paid or incurred in the ordinary course of a taxpayer's business (e.g., including employee wages and benefits).

Existing state law authorizes hiring tax credits, as well as other business tax incentives, which are intended to encourage business expansion and hiring in economic development areas, including Enterprise Zones (EZ), Targeted Tax Areas (TTA), Manufacturing Enhancement Areas (MEA), and Local Agency Military Base Recovery Areas (LAMBRA).

The Unemployment Insurance (UI) Program provides weekly unemployment insurance payments for workers who lose their job through no fault of their own. The UI Program is financed by employers that pay unemployment taxes on up to $7,000 in wages paid to each worker.

Board Position:			Department Director	Date
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THIS BILL

This bill would allow a credit to a qualified taxpayer that employs a qualified employee during the taxable year. The credit would be equal to:

- 100% of qualified wages in the first year of employment.
- 80% of qualified wages in the second year of employment.
- 60% of qualified wages in the third year of employment.
- 40% of qualified wages in the fourth year of employment.
- 20% of qualified wages in the fifth year of employment.

In the case of employees hired during any particular taxable year of the qualified taxpayer, this bill would require the use of a blended credit percentage. For example, if a qualified employee was hired on March 1st by a calendar year qualified taxpayer, then in the following taxable year the employee's wages would be subject to a 100% credit rate for January and February, and an 80% credit rate for the remainder of that second taxable year, and so forth.

This bill defines "qualified wages" as wages paid or incurred to an employee in excess of the state average weekly wage. Wages received during the five-year employment with the qualified taxpayer begin on the first day of employment. If an employee is re-employed due to an increase in the qualified taxpayer's trade or business, that does not constitute commencement of employment.

This bill defines "state average weekly wage" as the wage paid by employers to employees covered by unemployment insurance as reported by the Employment Development Department (EDD).

This bill would exclude any wages that a credit is granted for the Joint Strike Fighter Contract, EZs, TTAs, MEAs, and LAMBRAs.

This bill defines "qualified employee" as:

- an individual who is first employed by the qualified taxpayer on or after January 1, 2004, and before January 1, 2009, and
- has not been employed by the qualified taxpayer for at least five years before the commencement of current employment with the qualified taxpayer.

This bill defines "qualified taxpayer" as a person or entity that meets the following conditions:

- the average of all weekly wages paid or incurred to nonmanagerial and nonsupervisorial employees, excluding overtime wages, is not less than the state average weekly wage, and
- offers all employees coverage in an employer-sponsored health insurance plan.

This bill would require the credit to be recaptured if the qualified taxpayer does not comply with the requirements of this bill.

Any unused credit could be carried forward indefinitely.

IMPLEMENTATION CONSIDERATIONS

This bill does not limit the number of years for the carryover period. The department would be required to retain the carryover on the tax forms indefinitely because an unlimited credit carryover period is allowed. Recent credits have been enacted with a carryover period limitation since experience shows credits typically are exhausted within eight years of being earned.

This bill would allow the credit for all wages paid that are in excess of the state average weekly wage, not just those who are being paid the state average. That is, highly paid employees' wages would be included under "qualified wages," thereby qualifying the employer for this credit. If the author intends to restrict the credit to a disadvantaged targeted group, similar to the economic development areas hiring credit, the bill would need to be amended.

The bill provides a recapture provision but does not provide a way to verify if the qualified taxpayer has complied with the requirements of this bill. Other hiring credits only require the taxpayer to recapture the credit if the employee is terminated within a specific number of days after commencement of employment. The author may wish to add similar language for ease of administration of the credit.

LEGISLATIVE HISTORY

AB 475 (Cogdill, 2001/2002) would have allowed a small business that is located in a qualified area a credit based on employees' wages. This bill failed to pass out of the first house by January 31 of the second year of the session.

SB 1121 (Margett, 2001/2002) would have allowed a credit to employers that pay wages to individuals who qualify for state disability insurance (SDI). This bill failed to pass out of the first house by January 31 of the second year of the session.

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 income tax law allows an employer an enterprise zone job credit for monthly wages of an employee that are subject to unemployment tax.

Minnesota income tax laws do not provide for any employee wage related credits.

Illinois, Massachusetts, Michigan, and *New York* income tax laws provide some type of employment wage related credit mainly for those employers who have a trade or business in an economic development area and that hire individuals of a specific targeted group. However, research did not find any tax credits for those wages paid in relation to unemployment insurance.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

Potential revenue losses for this bill over the initial three-year period are projected to be as follows:

Fiscal Year Cash Flow Impact Enactment Assumed After 6/30/03 $ Billions		
2003-4	**2004-5**	**2005-6**
-5	**-2**	**-2**

This analysis does not take into account any change in employment, personal income, or gross state product that may result from this measure.

Revenue Discussion

Employers pay roughly $10 billion in taxes annually. Approximately ½ of these taxes are likely to be paid by employers whose average wage is below the state average, thus qualified employers will pay about $5 billion in 2003-04. Employers whose average wages are high are likely to also have new employees with above average wages, so it is assumed that 80% of qualified employers would have qualified wages. Since the bill provides for a 100% credit for qualified wages in the first year of employment and 80% credit in the second, it is assumed that qualified employers with qualified employees would be able to reduce their taxes by at least 50%. The resulting annual revenue loss is thus $2 billion ($5 billion x 80%= $4 billion x 50%=$2 billion). The estimated revenue loss for FY 2003/04 reflects the fact that the credit is available only for employees hired after 1/1/2004.

ARGUMENTS/POLICY CONCERNS

This bill would have the effect of providing a double benefit for deductible wages by virtue of this credit and the ordinary deduction of these wages as an expense from the income of the trade or business.

This bill does not limit the credit to wages paid to employees that are employed within this state.

Credits generally are provided as a percentage of amounts paid or incurred. This bill would allow a 100% credit in the first year of employment, which is unprecedented.

This bill would allow employers to claim a credit for employees who are relatives of the taxpayer, and would allow self-employed taxpayers to claim the credit on their own wages.

LEGISLATIVE STAFF CONTACT

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