

# ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author: La Suer Analyst: Raul Guzman Bill Number: AB 2245

Related Bills: See Legislative History Telephone: 845-4624 Introduced Date: February 22, 2006

Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Employer Wages Paid To Qualified Disabled Veteran Credit

## SUMMARY

This bill would provide employers a 50 percent tax credit for wages paid to certain disabled veterans.

## PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to encourage employers to hire qualified disabled veterans.

## EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective upon enactment and operative for taxable years beginning on or after January 1, 2006.

## 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 trade or business, including employee wages and benefits.

Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers that incur certain expenses or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

### THIS BILL

This bill would provide a tax credit to taxpayers in an amount equal to 50 percent (50%) of qualified wages paid to employees who are qualified disabled veterans.

Board Position:

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\_\_\_\_\_ N      \_\_\_\_\_ OUA        X   PENDING

Department Director

Date

Selvi Stanislaus

3/30/06

This bill would allow a credit to taxpayers for wages paid or incurred, thus providing for both cash-basis and accrual-basis accounting methods.

This bill would define the following terms:

- “Qualified wages” -- wages paid or incurred by the taxpayer to qualified disabled veterans.
- “Qualified disabled veteran” -- an individual who satisfies all of the following:
  1. Employee of the taxpayer,
  2. Disabled during an armed conflict as a member of the Armed Forces, including the California National Guard, and
  3. Domiciled in California.
- “Seasonal employment” -- employment by a taxpayer that has regular and predictable reductions in trade or business operation in California.
- “Taxpayer” -- a person engaged in a trade or business operation in California.
- “Predecessor” -- an employer who acquires a major portion of a trade or business of another employer and does not terminate employment of qualified disabled veterans after acquisition.

This bill would require that if employment of the qualified disabled veteran is terminated by the taxpayer at any time during the first 270 days, or before the close of the 270th calendar day after the day in which that employee completes 90 days of employment, the taxpayer will not be allowed to claim the credit and will have to recapture the credit for the taxable year and all prior taxable years with respect to that employee.

This bill would allow employers to hire qualified disabled veterans for “seasonal employment” and not be bound by any of the rules that apply to non-seasonal employees. Taxpayers that hire seasonal employees do not need to rehire the same qualified disabled veterans the following seasons. Taxpayers that hire seasonal employees can terminate qualified disabled veterans before the season ends and still qualify for the credit.

This bill would excuse the taxpayer from having to recapture the credit due to termination of employment if the qualified disabled veteran was terminated for one of the following reasons:

- Terminated due to seasonal employment.
- Voluntarily leaves employment.
- Becomes disabled and is unable to perform the services.
- Terminated employment due to misconduct.
- Terminated employment due to a substantial reduction in trade or business operations.
- Replaced by other qualified disabled veterans to increase the number of employees and the hours of employment.

This bill would provide that the employment relationship between the taxpayer and a qualified disabled veteran would not be treated as terminated by either of the following:

- If a business changes ownership due to a corporate acquisition and the qualified disabled veteran continues to be employed by the acquiring corporation.

- If the business merges and the taxpayer retains a substantial interest in that trade or business and the qualified disabled veteran continues to be employed in that trade or business.

This bill would provide that the amount of the credit must be reduced by any other federal or state jobs tax credits such as LAMBRA, Manufacturing Enhancement Areas, Enterprise Zone, and the federal WOTC credits.

This bill would provide that:

- Recaptured credits cannot be offset by other credits.
- Taxpayers cannot take a deduction on the same wages or salaries used to compute this credit.

This bill would allow any unused credits to be “added to the credit” in the following six years, until the credit is exhausted.

This bill would provide that the Franchise Tax Board (FTB) prescribe the manner and form of maintaining documentation of the credits.

This credit would be allowed under the Personal Income Tax Law (PIT) and the Corporation Tax law (CTL).

All items mentioned above apply to both PIT and CTL; the items mentioned below only apply to the CTL.

This bill references Section 1563 (a) of the Internal Revenue Code relating to “controlled group of corporations,” but: 1) would change the percentage from “at least 80 percent” to “more than 50 percent,” and, 2) the determination would be made without regard to certain insurance companies and to stock owned by employee’s trusts, which are exempt from tax.

### IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author’s office to resolve these and other concerns that may be identified.

This bill does not provide a definition for “qualified employer.” It is recommended that the author add a “qualified employer” definition.

This bill does not provide a definition for “wages;” it provides a definition for qualified wages within the meaning of this section, but does not define the term “wages.” “Wages” are normally referenced to amounts subject to withholding or reference an Employment Development Department (EDD) definition. It is recommended that the author add a definition for “wages.”

This bill does not provide a carryover. The bill language states the excess credit can be “added to the credit;” it doesn’t state it can be applied to the following six taxable years. It is recommended that the author correct the language.

The intent of the author appears to be to limit the incentive provided by the bill to new hires, but the language of the bill extends the credit to wages paid to any employee that is a qualified disabled veteran, regardless of when that veteran was hired. Clarification is recommended.

This bill also provides for a credit recapture period for employers who terminate employment prior to 270 days of employment. If the employee was hired three years before the bill is enacted, the credit continues to apply, but the recapture would never operate because the veteran's employment has exceeded 270 days.

The definition of a "qualified disabled veteran" as provided by this bill is generic and does not specify a degree or percentage of disability. When the Armed Forces classify a member as disabled, they assign a percentage of disability. It is recommended that the author add a certification process, perhaps discharge papers can be used.

This bill would consider a qualified disabled veteran as someone who was disabled during an armed conflict and a member of the Armed Forces or the California National Guard. It is recommended the bill provide the definition of an "armed conflict."

This bill would require that an employee be domiciled in California. Clarification is needed to determine how a taxpayer or the FTB would determine that the veteran is domiciled in California. This would be corrected if the author changed "is domiciled in California" to "perform services in California."

### TECHNICAL CONSIDERATIONS

This bill provides that the amount of the credit must be reduced by the federal WOTC jobs tax credit. Under the version of Internal Revenue Code (IRC) Section 51 in effect as of January 1, 2005, the federal credit under IRC Section 51 is not available for wages paid after December 31, 2005. If that federal termination date is revised, FTB would interpret this language to mean the IRC as of January 1, 2005. Consequently, even if an employer gets a federal credit for wages paid after December 31, 2005, because the federal law is changed, they would not be required to reduce this credit by the federal credit. This bill should include a technical revision to the language so that this credit is reduced by the federal credit allowed under IRC Section 51 for federal purposes.

A technical error was found within the language. On page 4, lines 1-4, "Any deduction otherwise allowed under this part . . . shall be reduced by the amount of the credit, **prior to any reduction required by subdivision (g).**" Subdivision (g) doesn't require any reduction. Subdivision (g) discusses carryover.

It is recommended that the author make the technical corrections.

### **LEGISLATIVE HISTORY**

AB 2325 (Bates, 2003/2004) would provide employers a tax credit for wages paid to disabled employees. This bill failed to pass out of the second house.

AB 2801 (Horton, 2003/2004) would reinstate the jobs tax credit. The bill would provide the taxpayer a credit in an amount equal to 10 percent of wages paid to qualified employees who are

certified by the EDD to meet certain requirements. This bill failed to pass out of the originating house by the constitutional deadline.

SB 1121 (Margett, 2001/2002) would have allowed employers a credit in an amount equal to 40 percent of qualified wages paid to individuals who were state disability insurance recipients. This bill failed to pass out of the originating house by the constitutional deadline.

### **OTHER STATES' INFORMATION**

*Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York* have no comparable credit. The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

### **FISCAL IMPACT**

The department's costs to administer this bill cannot be determined until implementation concerns have been resolved but are anticipated to be minor.

This bill would require a calculation for the credit that would require a new form or worksheet to be developed. As a result, this bill would impact the department's printing, processing, and storage costs for tax returns. The additional costs have not been determined at this time. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested.

### **ECONOMIC IMPACT**

#### Revenue Estimate

Based on data and assumptions discussed below, the PIT and Corporation Tax revenue loss from this bill would be as follows:

Estimated Impact of AB 2245 on California Applicable for tax years beginning on or after 1/1/06, Assumed enacted after 6/30/06 (Rounded to Nearest Million)			
Fiscal Year	2006-07	2007-08	2008-09
Disabled Veteran Hiring Credit	-\$1,400	-\$2,400	-\$2,400

This bill does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

#### Revenue Discussion

According to Census data, the number of veterans working in California with an "employment disability" is roughly 160,000. Census 2000 data indicates the average earnings of disabled veterans are about \$47,000 annually. This equates to a tax value of about \$23,500 per qualified employee. Credits earned for currently employed disabled veterans will be approximately \$3.8

billion (160,000 x \$23,500) in 2006. Many employers may respond to this credit by hiring additional disabled veterans. If hiring were to increase 20 percent in response to this proposal, 2007 credits generated would be approximately \$4.5 billion. Credit usage will be offset because taxpayers may not claim this credit for employees for whom they are already claiming other hiring credits and because they may not claim a deduction for credited wages. This estimate assumes these offsets will be about 20 percent of the credit amount. The estimate also assumes that taxpayers will only have sufficient liability to apply only 50 percent of credits generated. Credits applied in 2006 will be about \$1.5 billion (\$3.8 billion x 80% x 50%). The estimates presented in the table above are adjusted to reflect fiscal year impacts.

## **LEGAL IMPACT**

This bill would require that an employee be domiciled in California in order to be a qualified disabled veteran. A requirement to be a California domiciliary may be subject to constitutional challenge under the Commerce Clause of the United States Constitution.

## **POLICY CONCERNS**

Because this bill does not specify otherwise, the credit could be allowed for employees that were hired many years earlier.

This bill does not require certification of disability. Other hiring credits have been enacted with a voucher requirement for purposes of certifying the taxpayer's eligibility for the credit. To avoid any confusion between the department and taxpayers, the author may wish to amend the bill to clarify who is a "qualified disabled veteran," such as percentage of disability, place of disability, and date of disability. The definition of disabled veteran could be further clarified by providing reference to a determination made by the Military Departments, the Department of Defense, and/or the Department of Veterans Affairs.

This bill does not contain a sunset date. Sunset dates generally are provided to allow periodic review by the Legislature.

## **LEGISLATIVE STAFF CONTACT**

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