Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Arambula	Analyst:	Nicole Kwon	Bill Number:	AB 2601
Related Bills:	See Legislative History	Telephone:	845-7800	Amended Date:	August 8 & 9, 2006
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT:	Economic Incentive Areas

SUMMARY

This bill would make various changes and reforms to existing law regarding Enterprise Zones, Manufacturing Enhancement Areas, Targeted Tax Areas, and Local Agency Military Base Recovery Areas.

This analysis addresses only those provisions of the bill affecting the Franchise Tax Board (FTB).

SUMMARY OF AMENDMENTS

The August 9, 2006, amendments changed the author of the bill.

The August 8, 2006, amendments struck the previous provisions relating to the California International Trade and Investment Act and would make revisions to the law applicable to the following Economic Development Areas (EDAs):

A. Hiring Credit.
B. Net Interest Deduction.
C. Business Expense Deduction.
D. Net Operating Loss.

Each item is discussed separately below.

This is the department's first analysis of this bill.

PURPOSE OF THE BILL

According to the author's office, the purpose of the bill is to enact meaningful reforms to the EDA programs to ensure that the state maximizes its investment in the programs and targets benefits to economically challenged areas and individuals.

EFFECTIVE/OPERATIVE DATE

If enacted in 2006, this bill would be effective January 1, 2007, and operative for taxable years beginning on or after that date.

Board Position:			Department Director	Date
_______ S	_______ NA	_______ NP	Lynette Iwafuchi	9/6/06
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POSITION

Pending.

ANALYSIS

A. Hiring Credit

STATE LAW

Under the Government Code, state law provides for several types of EDAs: Enterprise Zones (EZs), Manufacturing Enhancement Areas (MEAs), Targeted Tax Areas (TTAs), and Local Agency Military Base Recovery Areas (LAMBRAs).

The Revenue and Taxation Code provides an income and franchise tax hiring credit for taxpayers operating in an EDA.

A business located in an EDA is eligible for a hiring credit equal to a percentage of wages paid to qualified employees. A qualified employee must be hired after the area is designated as an EDA and meet certain other criteria. At least 90% of the qualified employee’s work must be directly related to a trade or business located in the EDA and at least 50% of the employee's services must be performed inside the EDA.

The credit is based on the lesser of the actual hourly wage paid or 150% of the current minimum hourly wage (under special circumstances for the Long Beach EZ, the maximum is 202% of the minimum wage). The amount of the credit must be reduced by any other federal or state jobs tax credits, and the taxpayer’s deduction for ordinary and necessary trade or business expenses must be reduced by the amount of the hiring credit. Certain criteria regarding whom may be a qualified employee and certain limitations differ between the various EDAs.

Taxpayers operating in an EDA are allowed the hiring credit for employing “qualified employees.” “Qualified employees” for EDAs are defined by reference to various state and federal public assistance programs. The categories of individuals considered qualified employees for the various EDAs are substantially similar but not identical. A taxpayer located in an EDA is allowed a credit of up to 50% of wages paid to “qualified employees.” The taxpayer is required to obtain a voucher certificate for each of its “qualified employees.” The voucher certificates are issued by the California Employment Development Department (EDD) or the local (within the same EDA as the workplace of the employee) agency familiar with the public assistance statutes.

Existing state law allows local governments administering an EZ to issue vouchering certificates for the hiring credit. DHCD is authorized to develop regulations that govern the issuance of vouchering certificates by these local governments.

For MEAs, LAMBRAs, and TTA, EDD and the local entities that administer the Job Training Partnership Act and Greater Avenues of Independence Act (GAIN) have the authority to issue the voucher certificates. The voucher certificate indicates that the employee is qualified for or is receiving any of the specified forms of public assistance and thus is a “qualified employee” for purposes of the hiring credit.

Taxpayers that claim the hiring credit are required to retain a copy of the voucher certificate for each of its "qualified employees." Upon the request of FTB, the taxpayer is required to provide the voucher certificate for purposes of verifying the hiring credit claimed by the taxpayer.

THIS BILL

This bill would do the following:

- Extinguish the availability of the existing hiring credit for taxpayers operating in individual EDAs as of January 1, 2007, and provide a revised hiring credit for taxpayers operating in a "geographically targeted economic development area" for taxable years beginning on or after January 1, 2007.
- Define "geographically targeted economic development area (G-TEDA)" to mean areas designated as EZs, MEAs, TTAs, and LAMBRAs.
- Revise the requirements for qualified employees to require certain employees to be enrolled and documented in the California Job Training Automation System by an authorized federal Workforce Investment Act (WIA) representative.
- Revise the requirements for the category of qualified employees to require receipt of benefits under California Work Opportunity and Responsibility to Kids program.
- Define "economically disadvantaged individual" and "dislocated worker" as an individual who meets the definition of those terms under the WIA.
- Require applications for voucher certificates to be submitted to the certifying agency within 24 months of the commencement date of employment with the taxpayer.
- Clarify the requirement for employers to obtain a voucher certificate from the local agency in the area in which the employee is employed.
- Revise the definition of veterans to include an individual who served in the active military, naval, or air service and who was discharged or released from that service other than dishonorable or any veteran who was discharged or released in the last 48 months from active military, naval, or air service.
- Revise the definition of qualified employees to include an individual with a prior felony conviction.
- Add a "qualified former foster care recipient" to the list of qualified employees for the hiring credit. A "qualified former foster care recipient" would mean an individual who is certified by the local designated agency to have met both of the following: (1) attained age 17 but not age 25 on the hiring date, and (2) before attaining the age of 18, has been either a recipient of foster care maintenance payments under a state plan approved under the Social Security Act, or in foster care under the responsibility of a state.

IMPLEMENTATION CONSIDERATIONS

This bill would raise the following implementation considerations.

The term "G-TEDA coordinator" is undefined in this bill. It is assumed that "G-TEDA coordinator" is the person who administers all the rules and regulations of G-TEDA. If this assumption is inconsistent with the author's intent, the author's office may want to define this term or specify by cross reference the section of the law if it is already defined.

This bill would require a qualified former foster care recipient to be certified by the local designated agency. Currently, the taxpayer is required to obtain a voucher certificate for each of its “qualified employees.” The voucher certificates are issued by EDD or the local (within the same EDA as the workplace of the employee) agency familiar with the public assistance statutes. The author’s office may want to remove the provision that would require a qualified former foster care recipient to be certified by the local designated agency because there are already identified agencies issuing certification for “qualified employees” under the statute. If the author’s intention is to designate an agency other than the ones already provided under the statute, then it is suggested that the agency be designated in the bill.

TECHNICAL CONSIDERATION

There is a disparity between the cease operative date of January 1, 2007, and the operative date for the new hiring credit under G-TEDA which creates a gap in authority for the hiring credits for fiscal year taxpayers. “Taxable years beginning on or after” should be added in front of “January 1, 2007” to address the gap issue.

On page 39, lines 9 to 12, this bill defines “G-TEDA expiration date” as “the date G-TEDA designation expires, is no longer binding, or becomes inoperative.” The language should be revised to make G-TEDA expiration date the date of the underlying designation as an EZ, LAMBRA, MEA, or TTA.

On page 42, line 10, the term “zone” should be changed to “designation.”

On page 45, lines 38 to 40, the language of the new credit reiterates language from existing law that reduced the credit by the amount of the federal credit under the Internal Revenue Code (IRC) section 51. IRC section 51 has an expiration date that is regularly extended. To distinguish the federal credit available under IRC section 51, “as applicable for federal purposes” should be added after “Internal Revenue Code” on line 40.

On page 46, line 12, “Section 17053.70” should be changed to “Section 17053.76.”

LEGISLATIVE HISTORY

SB 1008 (Ducheny/Machado, 2005/2006) is identical to this bill except SB 1008 included provisions to expand the information FTB is required to annually make available to the Legislature. SB 1008 is currently in the Assembly Jobs, Economic Development and the Economy Committee.

AB 485 (Arambula, 2005/2006) would, among other provisions, define “geographically targeted economic development area (G-TEDA)” to mean areas designated as EZs, MEZs, TTAs, and LAMBRAs. AB 485 is currently in Senate Appropriations.

SB 1097 (Senate Budget Comm., Stat. 2004, Ch. 225) authorized local governments to issue vouchering certificates and authorized DHCD to issue emergency regulations to allow local governments to assess a fee for the administration of the EZ hiring credit.

OTHER STATES' INFORMATION

Florida allows businesses located in an EZ a credit based on wages paid to new employees. Other wage-based credits are offered to businesses that are located in high crime areas or in rural areas. Job tax credits are earned by employers, if hired employees reside in the designated EZ or a rural county. Up to 45% of an employee's wages may be claimed as a job tax credit.

New York allows a wage credit to a business that hires a full time employee (either one in a targeted group or not) for a newly created job in an Empire Zone.

Illinois, Massachusetts, Michigan, and *Minnesota* do not offer a wage credit to small business employers.

Texas allows EZs to be designated for any census block group with a poverty rate of 20% or more. Currently there are 169 EZs with no limitation on the number of zones in existence at any one time. Businesses operating in an EZ may claim a hiring credit of up to $1.25 million per year, if 25% of their jobs are reserved for low-income individuals.

Virginia currently designated 52 EZs, on a competitive basis, for 20-year durations.

Most of these states offer assistance such as financial, marketing, licensing, recruiting employees, tax seminars, and training to small businesses.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

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

Estimated Revenue Impact of AB 2601 Effective On Or After January 1, 2007 Enactment Assumed After June 30, 2006 ($ in Millions)			
Former Foster	2006-07	2007-08	2008-09
Care Recipients	-$4	-$6	-$5

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

Revenue Discussion

Based on data from the Department of Social Services, about 48,000 people in California aged 17 through 24 are former foster care recipients (an increase of about 6,000 individuals from the 18 through 24 age group). This estimate assumes that 67% of the former foster care recipients are employed. Statewide, about 6% of employees work for taxpayers claiming EZ credits. This estimate assumes that the same proportion (6%) of former foster care recipients work for employers claiming EZ credits. It is also assumed that 50% of the workers qualified under this provision are already being claimed by their employer under other EZ criteria. Thus, the number of new EZ credits generated by this bill would be approximately 960 (48,000 x 2/3 x 6% x 50% = 960).

Assuming an average of about $6,000 in hiring credits per qualified employee per year, the addition of former foster care recipients would cause an increase in credits of about $6 million a year (960 x $6,000). The estimate assumes that after this new category of worker is created, taxpayers will adjust their behavior by hiring 20% more of these workers. It is assumed that about 60% of credits earned will be applied in the year they are generated, and the rest will be carried forward. Estimates presented in the table above have been adjusted to reflect fiscal year impacts.

This estimate assumes that the number of people who received foster care outside of California, then moved to California, is equal to the number of California foster care recipients that have moved out of state.

B. Net Interest Deduction

ANALYSIS

STATE LAW

A deduction from income is allowed for the amount of net interest earned on loans made to a trade or business located in an EZ. Net interest is defined as the full amount of the interest less any direct expenses (e.g., commission paid) incurred in making the loan. The loan must be used solely for business activities within the EZ, and the lender may not have equity or other ownership interest in the EZ trade or business. This incentive is not available for LAMBRAs, MEAs, or TTAs.

THIS BILL

This bill would limit the deduction to interest received on loans made to businesses that are physically located within the EZ and do not have physical locations outside the EZ.

This bill requires lenders to verify and document that the loan proceeds are spent within the EZ to qualify for the deduction.

IMPLEMENTATION CONSIDERATIONS

This bill would raise the following implementation consideration.

The author's office may want to revise the language on both the personal income and corporation tax law sections to state clearly how the loan proceeds should be spent within the EZ to qualify for the deduction. For example, to qualify for the deduction, the loan proceeds are spent for expenditures for assets used in or services received in an EZ.

LEGISLATIVE HISTORY

SB 1008 (Ducheny/Machado, 2005/2006) is identical to this bill except SB 1008 included provisions to expand the information FTB is required to annually make available to the Legislature. SB 1008 is currently in the Assembly Jobs, Economic Development and the Economy Committee.

OTHER STATES' INFORMATION

Florida, Massachusetts, Michigan, Minnesota, and *New York* laws do not provide a deduction comparable to the deduction allowed by this bill. The laws of these states were reviewed because their tax laws are similar to California's income tax laws.

Illinois has a Growing Economy Tax Credit Act that provides tax credits to businesses creating new jobs and making capital investments. A taxpayer that has entered into an agreement under the Growing Economy Tax Credit Act is allowed a credit against the tax. The Department of Revenue and the Illinois Business Investment Committee determine the amount and duration of the credit, which must not exceed 10 taxable years. Under Illinois law, a subtraction is allowed to financial organizations for interest from a loan or loans to a borrower, to the extent the loan is secured by property that is eligible for the EZ investment credit.

FISCAL IMPACT

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

ECONOMIC IMPACT

This portion of the bill would have insignificant impact on the amount of revenue associated with existing and future EZs.

C. Business Expense Deduction

ANALYSIS

STATE LAW

A business located in an EDA (except an MEA) may elect to deduct as a business expense a specified amount of the cost of qualified property purchased for exclusive use in the EDA. The deduction is allowed in the taxable year in which the taxpayer places the qualified property in service. For LAMBRA businesses, the amount of the deduction is added back to the taxpayer's income if, at the close of the second year, the taxpayer does not have a net increase of one or more jobs (defined as 2,000 paid hours per employee per year). The property's basis must be reduced by the amount of the deduction. For EZs, LAMBRAs, and TTA, the maximum deduction for all qualified property is the lesser of 40% of the cost or the following:

	The applicable … amount is:
Taxable year of designation	$100,000
1st taxable year thereafter	100,000
2nd taxable year thereafter	75,000
3rd taxable year thereafter	75,000
Each taxable year thereafter	50,000

<u>THIS BILL</u>

This bill would increase the business expense deduction from 40% to 60%.

This bill would expand the cap on deductions to $100,000 for any year in the EZ.

<u>IMPLEMENTATION CONSIDERATIONS</u>

Implementing this bill would not significantly impact the department's programs and operations.

LEGISLATIVE HISTORY

SB 1008 (Ducheny/Machado, 2005/2006) is identical to this bill except SB 1008 included provisions to expand the information FTB is required to annually make available to the Legislature. SB 1008 is currently in the Assembly Jobs, Economic Development and the Economy Committee.

OTHER STATES' INFORMATION

Illinois conforms to federal provisions of allowing taxpayers to treat the cost of certain tangible property that is acquired by purchase for use in the active conduct of a trade or business as an expense not chargeable to a capital account. The limitation on the deductible cost of the property is increased by either the lesser of $35,000 or the cost of the property placed in service during the taxable year.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of AB 2601 Effective Date 1/1/2007 Fiscal Year ($ in Millions)			
	2006-07	2007-08	2008-09
Expensing	(minor)	-$1	(minor)

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

Revenue Discussion

Revenue loss would result from the revised limits on the expense deductions by businesses. Current law for expensing allows 40% of up to $50,000 ($50,000 x 40% = $20,000). This bill would allow 60% of up to $100,000 ($100,000 x 60% = $60,000). This bill's provision of $60,000 is triple the amount of $20,000 under current law. This bill would triple the limit on qualified expenses per taxpayer. It is estimated that this would result in approximately $15 million annually in new qualified expenses. This would result in a revenue loss of about $1 million in tax year 2007. Thereafter, the revenue loss diminishes because current expensing will be offset by reduced depreciation of assets that were expensed in earlier years.

D. Net Operating Loss (NOL)

ANALYSIS

STATE LAW

A business located in an EDA may carry over 100% of the EDA net operating losses (NOLs) to deduct against EDA income in future years. The NOL carryover is determined by computing the business loss that results from business activity in the EDA. The carryover period for NOLs is 15 years.

For businesses operating inside and outside an EDA, the amount of credit or NOLdeduction that may be claimed is limited by the amount of tax on income attributable to the EDA. Income is first apportioned to California using the same formula as that used by all businesses that operate inside and outside the state (property, payroll, a double-weighted sales factor). This income is further apportioned to the EDA using a two-factor formula based on the property and payroll of the business.

THIS BILL

This bill would make the rules for NOLs in the various EDAs (EZs, LAMBRAs, and TTAs) uniform. It would accomplish uniformity by making the following changes:

- Extend the carryover period for deducting an EDA NOL from 15 to 17 years.
- Eliminate the rules applied to determine the amount of an NOL attributable to an EDA, and
- Eliminate application of the apportionment formula for determining the income against which the EDA NOL may be deducted.

IMPLEMENTATION CONSIDERATION

This bill would raise the following implementation consideration.

This bill would retain existing law which provides that for purposes of computing the NOL amount (subject to carryover), the loss is limited to the loss attributable to the taxpayer's business activity in the EDA. The bill, however, would also eliminate the rules for determining "loss attributable to the taxpayer's business activity in the economic development area." This definition is needed to determine the limitation.

LEGISLATIVE HISTORY

SB 1008 (Ducheny/Machado, 2005/2006) is identical to this bill except SB 1008 included provisions to expand the information FTB is required to annually make available to the Legislature. SB 1008 is currently in the Assembly Jobs, Economic Development and the Economy Committee.

AB 511 (Alquist, Stats. 2000, Ch. 107) incrementally increased the general NOL from 50% to 65% and increased the carryover period from five to ten years.

AB 2065 (Oropeza, Stats. 2002, Ch. 488) suspended the deduction for general NOLs, increased the carryover percentage to 100% of the loss for tax years beginning on or after January 1, 2004, and extended withholding on real property to nonresidents.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

Based on the discussion below, the revenue loss from this bill is as follows:

Estimated Revenue Impact of AB 2601 Effective Date 1/1/2007 Fiscal Year ($ in Millions)			
	2006-07	2007-08	2008-09
NOLs	-$2	-$7	-$6

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

Revenue Discussion

This provision of the bill would have an immediate impact on revenue due to liberalization of the use of NOLs in EDAs.

Average NOL usage for 2000, 2001, 2002, and 2004 (NOLs were suspended in 2003) was $35.3 million. The estimate assumes that the cost of provision for this bill would be triple the cost of current law. The net revenue impact of this bill is derived by subtracting the cost of current law from the cost of the proposed law. [($35 million x 3 = $106 million) - $35 million = $71 million)]. An average tax rate of 8% was applied for the final impact ($71 million x 8% = $5.6 million), rounded to the nearest whole million to $6 million. The results in the table above have been adjusted to reflect fiscal year estimates.

POLICY CONSIDERATION

Eliminating the current law provision that allows the taxpayer's California source business income NOL attributable to EDAs to be applied only to business income generated from EDAs will create a question as to how NOL losses that have already been incurred and subject to carryover provisions will be used in the future years.

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