# ANALYSIS OF ORIGINAL BILL

**Franchise Tax Board**

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| Author: | Charles Calderon | Analyst: | Jahna Alvarado | Bill Number: | ABX3 35 |
| Related Bills: | See Legislative History | Telephone: | 845-5683 | Introduced Date: | September 05, 2008 |
| | | Attorney: | Patrick Kusiak | Sponsor: | |

**SUBJECT**: Enterprise Zone Tax Incentives/Suspend Operation For Taxable Years Beginning On Or After January 1, 2009.

## SUMMARY

This bill would suspend the operation of the Enterprise Zone (EZ) special tax incentive provisions for taxable years beginning on or after January 1, 2009.

## PURPOSE OF THE BILL

According to the bill language, the purpose of this bill is to address the fiscal emergency declared by the Governor pursuant to the California Constitution.

## EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately and specifically operative for taxable years beginning on or after January 1, 2009.

## POSITION

Pending.

## ANALYSIS

### FEDERAL/STATE LAW

Existing federal law provides for the existence of empowerment zones and enterprise communities to provide economic revitalization of distressed urban and rural areas.

Under the Government Code, existing state law allows the governing body of a city or county to apply for designation as an EZ. Using specified criteria, Department of Housing and Community Development designates EZs from the applications received from the governing bodies. EZs are designated for 15 years.

Under the Revenue and Taxation Code (R&TC), existing state law provides special tax incentives for taxpayers conducting business activities within EZs. These incentives include a hiring credit, a wage credit, sales or use tax credit, business expense deduction, net interest deduction, and special net operating loss treatment.

| Board Position: | | | Department Director | Date |
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**Hiring Credit:** A business in an EZ is eligible for a hiring credit equal to a percentage of wages paid to qualified employees employed in an EZ. A qualified employee must be hired after the area is designated as an EZ 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 EZ and at least 50% of the employee's services must be performed inside the EZ.

The credit is based on the lesser of the actual hourly wage paid or 150% of the current minimum hourly wage[1] (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.

Taxpayers operating in an EZ are allowed the hiring credit for employing "qualified employees." "Qualified employees" for EZs are defined by reference to various state and federal public assistance programs. A taxpayer located in an EZ is allowed a credit of up to 50% of wages paid to "qualified employees" in the first year, decreasing by 10% each year thereafter. The taxpayer is required to obtain a voucher certificate for each of its "qualified employees." The voucher certificates are issued by the Employment Development Department or the local (within the same EZ as the workplace of the employee) agency familiar with the public assistance statutes.

**Wage Credit**. A credit is available to a "qualified employee," who earns "qualified wages." The credit is equal to 5% of the employee's "qualified wages" for the year. Qualified wages are those wages attributable to services performed by a qualified employee that do not exceed 150% of the minimum wage for any taxable year[1]. Qualified wages do not include compensation received from the federal government, the state of California, or a local government. In addition, qualified wages do not include any wages received on or after the date the EZ designation expires, is no longer binding, or becomes inoperative.

**Sales or Use Tax Credit:** The sales or use tax credit is allowed for an amount equal to the sales or use taxes paid on the purchase of qualified machinery purchased for exclusive use in an EZ. Currently, the credit is for the total cost of qualified property purchased and placed in service in any taxable year. The total costs of qualified property may be in an amount not to exceed $1 million under the Personal Income Tax Law (PITL), and $20 million under the Corporation Tax Law (CTL).

**Business Expense Deduction:** A taxpayer engaged in a trade or business within an Enterprise Zone (EZ), may elect to treat 40% of the eligible cost of a qualified property as a business expense rather than a capital expense. The deduction is allowed for the taxable year in which the property is placed in service. Qualified property must be purchased and placed in service by the taxpayer for exclusive use in a trade or business conducted within an EZ.

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[1] Minimum wage is defined as the wage established by the California Industrial Welfare Commission under Chapter 1 of Part 4 of Division 2 of the Labor Code per R&TC section 17053.74(b)(1)(C)(2). As of January 1, 2008, the minimum wage is $8.00. Thus, for calculating qualified wages, the maximum hourly rate is $12.00 (150% x $8.00).

**Net Interest Deduction:** Under the CTL, a taxpayer that loans funds to a person or entity engaged in a trade or business located solely within an EZ may deduct the net interest income. The net interest deduction is for interest payments received after the designation of the EZ and before its expiration.

**Net Operating Loss (NOL):** An EZ NOL is the loss attributable to the taxpayer's business activities within an EZ, prior to the EZ expiration date. The EZ NOL carryover is limited to the lesser of the EZ NOL or the business NOL[2]. To claim the special NOL, a taxpayer must make an irrevocable election designating whether the loss is being claimed for a business located in an EZ.

Under the R&TC, NOLs are suspended for taxable years 2008 and 2009 for taxpayers with net business income (PITL) or business income subject to tax (CTL) equal to or greater than $500,000. The carryover period for NOLs attributable to taxable years beginning on or after January 1, 2008 is extended to 20 years, and a 2 year carryback for NOLs attributable to taxable years beginning on or after January 1, 2011 is allowed.

Under general provisions regarding credits, unless otherwise provided, any remaining carryover of a credit allowed by a section that has been repealed or made inoperative shall continue to be allowed to be carried over under the provisions of the section as it read immediately prior to being repealed or becoming inoperative.

## THIS BILL

This bill would make the EZ special tax incentive provisions of the Revenue &Taxation Code inoperative for taxable years beginning on or after January 1, 2009.

Since the bill does not include language that provides otherwise, EZ credits carried over from taxable years beginning before January 1, 2009, would continue to be allowed.

## IMPLEMENTATION CONSIDERATION

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

This bill provides that enterprise zone incentives would be inoperative for tax years beginning on or after January 1, 2009. This bill fails to address carryover or recapture amounts that may arise after the law becomes inoperative. However, under current law[3] a carryover credit arising under prior law continues after the underlying statute become inoperative. There is no similar law on recapture of credits. The author may wish to add language clarifying recapture requirements of EZ credits to minimize taxpayer confusion.

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[2] For California purposes, several different business NOL provisions are available. Each NOL has different qualifications, as well as different carryover percentages and periods.
[3] R&TC sections 17039(d) and 23036(f).

## LEGISLATIVE HISTORY

AB 1452 (Committee on Budget, Stats. 2008, Ch. 763) limits the allowable business credit to 50% of the total tax prior to application of any credits and suspends the NOL for taxpayers with business income equal to or greater than $500,000 for taxable years 2008 and 2009. Any disallowed credit or suspended NOL may be carried forward. AB 1452 extends the NOL carryover period to 20 years and allows a two year carryback for NOLs, subject to a two year phase in period, attributable to years beginning on or after January 1, 2011.

AB 1452 also allows a taxpayer that is a member of a combined reporting group to make a one time, irrevocable assignment of business tax credits to taxpayers within that group. Assigned credits must have been earned during a taxable year beginning on or after July 1, 2008 or eligible for carryover to the taxpayer's first taxable year beginning on or after July 1, 2008. Assigned credits can only be applied to reduce a tax liability in taxable years beginning on or after January 1, 2010.

SB 1876 (Alpert 2003/2004) would have repealed the EZ special tax incentive provisions for tax years beginning on or after January 1, 2013. SB 1876 failed to pass out of the Senate Appropriations Committee.

## OTHER STATES' INFORMATION

The *Florida* Enterprise Zone Act of 1994 was scheduled to be repealed on December 31, 2005, but was re-enacted as the Florida Enterprise Zone Act by chapter 2005-287, L.O.F., for an additional ten years, and is now scheduled to be repealed December 31, 2015. Currently, *Florida* has 56 state enterprise zones.

*Illinois* has 94 enterprise zones, *Michigan* has in excess of 150 geographic areas designated as Renaissance Zones, and *New York* has 82 Empire Zones. Each of these states' designated zone programs do not appear to have an expiration date. The states were reviewed due to their similarities to California's economy, business entity types, and tax laws.

## FISCAL IMPACT

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

## ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue gains:

| Revenue Impact of ABX3 35<br>Elimination of Enterprise Zone Incentives<br>Effective for taxable years beginning on or after 2009<br>Enactment Assumed After September 30, 2008 | | |
|---|---|---|
| ($ in Millions) | | |
| 2008/09 | 2009/10 | 2010/11 |
| +$20 | +$120 | +$180 |

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

The revenue gain attributable to this bill would depend on the value of EZ program incentives (credits, income exclusions, and deductions) that would otherwise have been used to reduce income tax liabilities absent this proposal.

The revenue gain generated by repealing EZ program incentives must be adjusted to account for (1) taxpayers that will continue to use carryover credits (amounts generated in prior years), (2) taxpayers that will use Research and Development (R&D) credits in place of EZ credits, and (3) taxpayers that would benefit from deducting all wage and sales/use tax expenses, which are disallowed while generating EZ credits.

Based on departmental data and taking into account recently enacted legislation impacting EZ program incentives, for taxable year 2009, total expenditures are projected to be $280 million. Of this total, approximately $245 million relate to wage and sales/use tax credits. It is anticipated that approximately 65% of these credits would continue to be used due to the availability of carryover credits, thus reducing the potential revenue gain to $85 million [$245 M x (1 - 65%)]. The ability to use R&D credits in place of EZ Credits and the deductibility of all wage and sales/use tax expenses are assumed to reduce potential revenue further by 10% to $75 million [$85 M x (1 - 10%)]. Repeal of all other EZ program incentives (income exclusion, accelerated depreciation, and employee wage credits) would increase revenues by an additional $35 million for taxable year 2009.

The net revenue gain of eliminating the EZ program is estimated to total approximately $110 million ($75 M + $35 M) for taxable year 2009. Similar estimates are made for later years. These liability year estimates are then fiscalized for the numbers presented in the table above.

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