STATE OF CALIFORNIA
Franchise Tax Board

New Employment Credit Report

Economic and Statistical Research Bureau

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This report is intended to fulfill the Franchise Tax Board's obligation under the Revenue & Taxation Code sections 17053.73 and 23626 to annually report by March 1, to the Joint Legislative Budget Committee, under these sections for the most recent fiscal year, the total amount of the credits claimed, a comparison of the total dollar amount of credits claimed under this section with respect to the department's estimate, and identify options for increasing annual claims of the credit so as to meet estimated amounts.

Prepared by the Staff of the
Franchise Tax Board
STATE OF CALIFORNIA

New Employment Credit

Background

Chapters 69 and 70 of the Statutes of 2013 (AB 93 and SB 90 respectively) created a New Hiring Tax Credit (also known as the New Employment Credit (NEC)) to employers operative for taxable years beginning on or after January 1, 2014, and before January 1, 2021. Chapter 52 of the Statutes of 2018 (SB 855) extended the credit's operative date through 2025. To obtain a credit, a qualified taxpayer must:

- Hire a qualified full-time employee on or after January 1, 2014;
- Pay qualified wages attributable to work performed by the qualified full-time employee in a designated census tract or economic development area;
- Receive a Tentative Credit Reservation from the Franchise Tax Board (FTB) (within 30 days of complying with the Employment Development Department's (EDD) new hire reporting requirement) for that qualified full-time employee; and
- In addition, a qualified taxpayer must annually certify each qualified employee.

The credit is based on 35 percent of qualified wages, or wages between 150 percent and 350 percent of minimum wage. The wage range will increase over time due to increases in the minimum wage rate.

In order to generate an allowable credit, the qualified taxpayer must have a net increase in its total number of full-time employees working in California, when compared to its base year both based on annual full-time equivalents.

In order to claim a generated credit on a tax return, the qualified taxpayer must have tax liability to offset. Otherwise, the credit is carried forward for potential use for up to five taxable years subsequent to the year the credit was generated.

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A qualified taxpayer:

- Is an employer engaged in a trade or business within a designated census tract or economic development area.
- Is not engaged in any excluded businesses, including temporary help services, retail trades, those primarily in food services, alcoholic beverage places, theater companies, dinner theaters, casinos, and casino hotels unless the business is considered a small business.
- Is not engaged in a sexually-oriented business.
- Hires an individual that is a qualified full-time employee that works at least an average of 35 hours per week and meets other specified wage requirements.

A qualified employee is an employee who meets at least one of the following five criteria:

- Is unemployed for the six months immediately preceding employment;
- Is a veteran who has not been employed since separation from service;
- Is a recipient of the federal earned income tax credit for the previous taxable year;
- Is an ex-offender immediately preceding employment; or
- Is a recipient of CalWORKS or general assistance immediately preceding employment.

FTB Outreach Efforts

Over the past few years the FTB has publicized the availability of the NEC via various outreach efforts including the following:

- Distributing informational brochures at approximately 60 small business events throughout the State in 2017, 40 during 2018, 33 in 2019, and approximately 10 more in 2020. The number of events during 2020 were severely impacted by COVID-19.
- Continuing to publish articles in FTB's Tax News online newsletter.
- Continuing work with the State Treasurer's Office for the California Business Incentives Gateway (CBIG) portal to include NEC information.
- Maintaining an interactive website with credit information, as well as online mapping, reservation, and employment certification tools.
- Continuing working with the California Department of Technology to keep the DGA map for census tracts functioning and useful for taxpayers.

FTB Statutory Reporting Requirements

The FTB is required to provide an annual report, by no later than March 1, to the Joint Legislativ e Budget Committee which includes the following:

- The total dollar amount of the credits claimed under this section with respect to the relevant fiscal year.
- A comparison of the total dollar amount of credits claimed under this section with respect to that fiscal year with the department's estimate with respect to that same fiscal year.
- Should the total dollar amount of credits claimed for the fiscal year be less than the estimate for that fiscal year, the report shall identify options for increasing annual claims of the credit so as to meet estimated amounts.

The information presented in this report is based on 2018 and 2019 tax return data processed as of January 2021. For information on NEC data for tax years 2017 and prior, please see the March 1, 2020, New Employment Credit Report.

Data Observations

In the March 1, 2020, NEC Report, with return data available at the time of that report, the FTB reported that $3.3 million of NEC credits were generated for the 2018 tax year. Additional 2018 tax year returns have since been processed, showing that $3.6 million of credits were generated with the amount of credit claimed remaining at $3.3 million. Based on return data available at the time of the current report, $1.3 million of NEC credits were generated for the 2019 tax year with the amount of credit claimed at $3.0 million. Credit claims can exceed the generated amount when taxpayers claim unused credits carried over from prior years.

The tax year totals are well short of initial program estimates. With six tax years of data available, it is evident that over time, taxpayers are claiming a larger percentage of the generated credit. Despite the increase in credit claims, it still does not appear that the program has sufficient incentives to induce desired taxpayer behavior. The FTB believes the following factors may be curtailing the use of NEC credits:

- <u>Complexity</u>: There are multiple standards a qualified employer and a qualified employee must meet in order for the employer to qualify to claim the credit. Complex programs are often associated with more frequent taxpayer return errors.
- <u>Claiming without a reservation</u>: There is some evidence that of those claiming the NEC, predominately for the first few tax years of the program, not all those claiming the credit made reservations and thus were not qualified to take the credit.

Credits Claimed: Estimates and Actual

At the time AB 93 was chaptered, the FTB released estimates that $229 million in credits would be claimed for the 2018 tax year, and $269 million for the 2019 tax year. As of the date of this report, taxpayers have reported $3.3 million claimed on 2018 tax year returns, and $3.0 million claimed on 2019 tax year returns. The 2019 totals do not include all fiscal-year filers.

Based on reviews of credits claimed, in particular during the first few years of the program, additional amounts of these credits were disallowed. For instance, on some returns claiming the NEC, some tax preparer software inadvertently claimed the NEC in lieu of other credits. The FTB has worked to identify this and other subsequent credit claimed adjustments to returns. Based on more current return filing data, it appears many of these early claim mistakes have been rectified.

Options for Increasing Annual Credits Claimed

Statute stipulates that if the total dollar amount of credits claimed for the fiscal year is less than the estimate for that fiscal year, this report should identify options for increasing annual claims of the credit to meet estimated amounts. Although specific reasons for the shortfall in credits claimed versus estimates are not readily available, the FTB has identified program features where changes might encourage taxpayers to utilize the program above current levels:

- <u>Change geographic limitations</u>: Current law stipulates that designated census tracts are geographic areas that have the highest unemployment and highest poverty in the State, in addition to former Enterprise Zones and former LAMBRAs. Expanding this requirement to include areas that currently do not qualify would increase credit use.
- <u>Change eligibility requirements</u>: Under current law, there are various qualifying restrictions for the hired employee in order for the employer to qualify for the credit. Reducing some or all of these restrictions will increase credit use by expanding the program to allow credit for additional new hires.
- <u>Change range of wages qualifying</u>: Under current law, qualified wages are that portion of wages paid or incurred that exceed 150 percent of minimum wage, but do not exceed 350 percent of minimum wage. As of January 1, 2021, the multiple of the minimum wage ranges are $19.50 to $45.50 for employers with 25 or fewer employees who are required to pay $13.00 per hour, and $21.00 to $49.00 for employers with 26 or more employees with minimum wage requirements of $14.00 an hour. Expanding the range of wages that qualify for the credit would promote credit use. For instance the wage range might be expanded by dropping the 150 percent of minimum wage requirement and allowing all wages exceeding the current minimum wage to qualify.

- Drop reservation requirement (or streamline reservations): Under current law, an employer must receive a Tentative Credit Reservation from the FTB within 30 days of complying with the EDD new hire reporting requirement to qualify an employee for the credit. Even after the FTB disallowed a number of first-and second-year NEC claims for not making a reservation, it did not see the number of reservations increase substantially in subsequent years. Relaxing some or all of the reservations requirements might increase participation.
- Expand to additional business types: Under current law, the employer may not be engaged in any excluded businesses, including temporary help services, retail trades, those primarily in food services, alcoholic beverage places, theater companies, dinner theaters, casinos, and casino hotels unless the business is considered a small business. The employer may not be engaged in a sexually-oriented business. Reducing the list of excluded business types would widen the pool of potential program participants.
- Change the credit percentage: The current credit is based on 35 percent of qualified wages. Increasing the credit percentage would naturally increase the amount of credits claimed.