

SECTION 16000 MANUFACTURING ENHANCEMENT AREA HIRING CREDIT

References 17053.47(a); 17053.47(b)(5)(B); 23622.8(a); 23622.8(b)(5)(B)

For each taxable year beginning on or after January 1, 1998, the California Revenue and Taxation Code (CR&TC) provides a hiring credit for "qualified" taxpayers who operate or invest in a business located within a designated Manufacturing Enhancement Area (MEA) and hire "qualified employees" and pay them "qualified wages". MEAs were established in California to stimulate development in selected economically depressed areas.

The MEA hiring credit applies to those employees hired after the designation date of the MEA (October 1, 1998).

- EDAM 16100 GEOGRAPHIC BOUNDARIES AND DESIGNATION DATES
- EDAM 16200 QUALIFIED TAXPAYER
- EDAM 16300 QUALIFIED WAGES
- EDAM 16400 QUALIFIED EMPLOYEE
- EDAM 16500 CREDIT COMPUTATION
- EDAM 16600 CREDIT USAGE & CARRYOVER
- EDAM 16700 RECORD KEEPING REQUIREMENTS

16100 Geographic Boundaries and Designation Dates

For a listing of MEAs, see "*MEA Locations and Designation Dates*" EDAM 1330. To verify an address, refer to EDAM 1300.

16200 Qualified Taxpayer

References 17053.47(b)(6); 23622.8(b)(6)

EDAM 16210	Pass-Through Entities
EDAM 16220	Controlled Groups
EDAM 16230	Acquired Businesses

A *qualified taxpayer* is any taxpayer engaged in a trade or business within an MEA and who meets all of the following requirements:

- Is engaged in those lines of business described in Codes 2011 to 3999, inclusive, of the *Standard Industrial Classification (SIC) Manual* published by the United States Office of Management and Budget, 1987 edition;
- At least 50 percent of the qualified taxpayer's work force hired after the designation of the MEA, is composed of individuals who, at the time of hire, are residents of the county in which the MEA is located; and
- Of this 50 percent of local hires, at least 30 percent were qualified disadvantaged individuals.

16210 Pass-Through Entities

The determination of whether a taxpayer is a qualified taxpayer is made at the entity level. The term "pass-through entity" means any partnership or S corporation. The hiring credit is allowed to the pass-through entity and passed through to the partners or shareholders.

16220 Controlled Groups

References 17053.47(c)(1)(A); 17053.47(c)(1)(C); 23622.8(c)(1)(A); 23622.8(c)(1)(C)

All employees of trades or businesses that are under common control, or members of the same controlled group of corporations, are treated as employed by a single taxpayer.

A controlled group of corporations is defined in IRC § 1563(a) as modified by the California Revenue & Taxation Code, to replace "*at least 80%*" with "*more than 50%*". The determination is made without regard to subsections (a)(4) and (e)(3)(C) of IRC § 1563.

NOTE: Controlled groups of taxpayers may not transfer employees between members to trigger or increase the credit.

16230 Acquired Businesses

References 17053.47(c)(2); 23622.8(c)(2)

For purposes of the hiring credit, if a major portion of a business is acquired from another employer, the employment relationship between the employee and the new employer shall not be treated as terminated if the employee continues employment in that business. Also, if a major portion of a separate unit of a business predecessor is acquired, the employment relationship between the employee and the new employer is not treated as terminated if the employee continues employment in that business.

NOTE: The new employer, “steps into the shoes” of the old employer for purposes of incurring future credits.

16300 Qualified Wages

References 17053.47(b)(1); 17053.47(b)(2); 17053.47(e); 23622.8(b)(1); 23622.8(b)(2)

EDAM 16310	Estates and Trusts
EDAM 16320	Non-Qualified Wages
EDAM 16330	Minimum Wage Chart
EDAM 16340	Annual Wage Limitation

Qualified wages are wages paid or incurred to employees (qualified) during the consecutive 60-month period beginning with the first day the employee commences employment with the taxpayer. For qualified employees hired before the expiration date of the MEA, qualified wages paid or incurred within the 60-month period beginning with the first day the employee commences employment with the taxpayer shall continue to qualify for the credit after the area expiration date, as if the MEA designation were still in existence and binding.

Qualified *wages* means that portion of hourly wages that does not exceed 150% of the minimum wage.

- Minimum wage means the wage established by the Industrial Welfare Commission. When the California minimum wage is higher than federal minimum wage, use the California minimum wage for purposes of this credit.
- To determine a salaried employee's hourly wage, divide the total salary by the average hours worked, normally 2,000 hours per year.

16310 Estates and Trusts

In the case of an estate or trust, apportion the qualified wages between the estate/trust and the beneficiaries on the basis of the income allocable to each. Consequently, any beneficiary, to whom wages are apportioned, is treated as the employer with respect to those wages.

16320 Non-Qualified Wages

Qualified wages *do not* include any wages paid or incurred on or after the area expiration date except as noted previously for qualified employees hired prior to the expiration of the MEA.

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16330 Minimum Wage Chart

EFFECTIVE DATE	MINIMUM WAGE	MAXIMUM HOURLY WAGE (150% of Minimum Wage)
March 1, 1998 to December 31, 2000	\$5.75	\$8.62
January 1, 2001 to December 31, 2001	\$6.25	\$9.37
January 1, 2002 to Current	\$6.75	\$10.12

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16340 Annual Wage Limitation

The total amount of qualified wages taken into account for purposes of claiming the credit shall not exceed two million dollars (\$2,000,000) each taxable year.

16400 Qualified Employee

References 17053.47(b)(5); 23622.8(b)(5)

EDAM 16410 Seasonal Employees

EDAM 16420 Leased Employees

A *qualified employee* is an individual who satisfies all of the following:

ANNUAL TESTS

- At least 90% of the employee's work for the taxpayer, during the taxable year, must be directly related to the conduct of the taxpayer's trade or business located in the MEA; **and**
- At least 50 percent of the employee's services for the taxpayer, during the taxable year, must be performed within the boundaries of the MEA;

TIME OF HIRE TESTS

- The employee is hired after the area was designated as a MEA; and
- Immediately preceding commencement of employment with the taxpayer, the employee is any of the following:
 - Eligible for services under the federal Job Training Partnership Act (JTPA) or its successor;
 - Registered under the Greater Avenues for Independence (GAIN) Act of 1985, or its successor; **or**
 - Certified eligible by the Employment Development Department under the federal Targeted Jobs Credit Program (TJTC), or its successor, whether or not this program is in effect.

16410 Seasonal Employees

References 17053.47(b)(1)(C); 17053.47(b)(7); 23622.8(b)(1)(C); 23622.8(b)(7)

"Seasonal employment" means employment that has regular and predictable substantial reductions in business operations.

Reemployment of an individual, in connection with any increase (including a regularly occurring seasonal increase) in business operations, does not constitute commencement of employment for purposes of the MEA hiring credit.

16420 Leased Employees

The "employer" is the qualified taxpayer and may qualify for the hiring credit for leased employees. The employer can be either the leasing company or the subscriber to the leasing company. Generally, the employer has the legal obligation to pay the payroll taxes of the employee, and has the right to control and direct the workers (employee's) services.

Internal Revenue Service (IRS) Publication 15-A, *Employer's Supplemental Tax Guide* provides guidelines for establishing an employment relationship and provides examples to consider in determining the employer-employee relationship.

16500 Credit Computation

References 17053.47(a); 17053.47(b)(1)(B); 23622.8(a); 23622.8(b)(1)(B)

EDAM 16510	Exclusive Credit
EDAM 16520	Reduction for Other Tax Credits
EDAM 16530	Wage Expense Reduction
EDAM 16540	Business Income Activity Limitation
EDAM 16550	General Provisions – Apportionment of Business Income
EDAM 16551	Property Factor – Income Apportionment
EDAM 16552	Payroll Factor – Income Apportionment
EDAM 16553	Apportionment – Combined Groups
EDAM 16554	Apportioning for Personal Income Tax Taxpayers
EDAM 16560	S Corporations

For each taxable year beginning on or after January 1, 1998, a hiring credit is allowed to a qualified taxpayer for hiring a qualified employee for employment within the MEA. The credit is equal to the sum of each of the following:

- 50% of the qualified wages during the first year of employment.
- 40% of the qualified wages during the second year of employment.
- 30% of the qualified wages during the third year of employment.
- 20% of the qualified wages during the fourth year of employment.
- 10% of the qualified wages during the fifth year of employment.

The total amount of qualified wages used to compute the MEA hiring credit cannot exceed \$2,000,000 per each taxable year.

The credit percentage is based on the employee's date of employment and subsequent anniversary dates. The taxpayer's tax year does not control the applicable credit percentages. With the exception of the first and last year of the credit, within one tax year, two percentage ranges for the computation of the credit may apply.

Example: An employee was hired 12/1/1998, and the taxpayer is completing the tax return for the year ending 12/31/1999. For the period 1/1/1999 to 11/30/1999, the hiring credit is based on 50% of qualified wages. For the period 12/1/1999 to 12/31/1999, the hiring credit is based on 40% of qualified wages.

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Once the employee commences employment, the credit percentage range begins and generally is not interrupted in the event of a subsequent layoff and rehire of the employee.

Example: An employee is hired 12/1/1998, is temporarily laid off 2/1/1999, and is rehired 4/1/1999. The 50% credit range runs from 12/1/1998 to 11/30/1999 regardless of the layoff period between 2/1/1999 and 3/31/1999.

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16510 Exclusive Credit

References 17053.47(i); 23622.8(h)

If the qualified taxpayer is allowed the MEA hiring credit for qualified wages paid to an employee, only that one credit is allowed to the taxpayer with respect to those qualified wages for that employee.

16520 Reduction for Other Tax Credits

References 17053.47(f); 23622.8(e)

The MEA hiring credit is reduced by the credits allowed under California Revenue & Taxation Code Section 17053.7 & 23621 (Jobs Tax Credit), and the federal credit allowed under IRC § 51 (Work Opportunity Tax Credit – WOTC).

NOTE: California conformed to IRC § 51 (as codified on 1/1/2001) for taxable years beginning on or after 1/1/2002. Thus, the WOTC will reduce the hiring credit for employees hired on or before 12/31/2001 (see IRC § 51(c)(4)). In prior years, California conformed to IRC § 51 for taxable years beginning on or after 1/1/1998. Thus, the WOTC reduced the hiring credit for employees hired on or before 6/30/1998 (see IRC § 51(c)(4)).

16530 Wage Expense Reduction

References 17053.47(f); 23622.8(e)

The taxpayer must reduce any deduction for wages by the amount of the MEA hiring credit allowed (including any current year credit to be carried forward).

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16540 Business Income Activity Limitation

References 17053.47(h)(2); 23622.8(g)(2)

The amount of the hiring credit claimed, including any credit carryover from prior years, may not exceed the amount of tax on the taxpayer's MEA business income in any year. Depending on the tax year involved, the MEA business income is that portion of the taxpayer's *California source* business income or the worldwide income that is apportioned to the MEA. Non-business income or loss is not included in the calculation of business income from the MEA. Each taxpayer claiming the credit must compute the MEA business income and resulting tax.

Example: Corp. A operates entirely within an MEA. In order to determine the amount of hiring credit allowable, the business income and the tax on that business income must be determined. Corp. A has the following items of income and expense:

Income from business operations	\$30,000
Interest from investment which is unrelated to Corp. A's business operations	2,000
Business expenses	(17,000)
Net taxable income before taxes	\$15,000

Corp. A's income attributed to business operations is:

Income from business operations	\$30,000
Business expenses	(17,000)
Net Business Income	\$13,000

To determine the MEA hiring credit allowable, the net business income is multiplied by the current tax rate.

Net Business Income	\$13,000
x 8.84%	<u>x .0884</u>
Tax associated with business income	\$1,149

In this example, the taxpayer can offset the tax of \$1,149 with the hiring credit available (up to \$1,149).

NOTE: "net tax"/"tax" and alternative minimum tax impose limitations on the allowable offset but were not considered a factor in this example.

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16550 General Provisions – Apportionment of Business Income

References 17053.47(h)(2); 17053.47(h)(3); 23622.8(g)(2); 23622.8(g)(3)

If a business is located within and outside of the MEA, the taxpayer must determine the portion of the total business income attributable to the MEA.

- Business income is defined under the provisions of the Uniform Division of Income for Tax Purposes Act (UDITPA).
- Components of the factors are defined under the provisions of UDITPA.

Business income is apportioned to the MEA by multiplying the taxpayer's *California* source business income by a fraction, the numerator of which is the property factor plus the payroll factor, and the denominator of which is two (2).

16551 Property Factor – Income Apportionment

The property factor is a fraction. The numerator of the property factor is the average value of the real and tangible personal property owned or rented and used or available for use by the taxpayer *within the MEA* during the taxable year. The denominator is the average value of all real and tangible personal property owned or rented and used or available for use by the taxpayer during the taxable year *within California*.

Rented property is valued at 8 times the net annual rental rate. The net annual rental rate is the total rent paid for the property, less any subrental rates paid by subtenants.

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16552 Payroll Factor – Income Apportionment

The payroll factor is a fraction. The numerator of the payroll factor is the total compensation paid to employees working for the taxpayer *within the MEA* during the taxable year. The denominator is the total compensation paid to employees working for the taxpayer *within California* during the taxable year.

Example: Corp. A operates within and outside the MEA. California business income of \$13,000 needs to be apportioned to the MEA. The following amounts apply to Corp. A's property and payroll:

MEA Property	\$40,000
CA Property	\$100,000
MEA Payroll	\$5,000
CA Payroll	\$10,000

MEA Property/CA Property	= .40	
MEA Payroll/CA Payroll	= .50	
	.90/2 = .45	MEA Apportionment Factor

Business income	\$13,000
Apportionment Factor	x 0.45
MEA Business Income	\$5,850
Current Tax Rate	x .0884
Tax attributable to MEA business income	\$ 517

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16553 Apportionment – Combined Groups

For members of a combined group, the limitation is based on the intrastate apportioned business income for each taxpayer doing business within the MEA. The numerator of the apportionment formula is based on each MEA taxpayer's separate MEA property and payroll amounts and the denominator is based on each MEA taxpayer's separate California property and payroll amounts.

Example: For the taxable year ending 12/31/99, parent corporation A has two subsidiaries, B and C. Corporations A and B operate within the MEA. The combined group operates within and outside California and apportions its income to California using Schedule R. The combined group's business income apportioned to California was \$1,000,000. Corporation A and B's share of California business income is \$228,000 and \$250,000 respectively. Corporation A and B's separate MEA and separate California property and payroll factor amounts are shown below.

Business income apportioned to the MEA was determined as follows:

	A	B
<u>Property Factor</u>		
MEA Property	\$1,000,000	\$ 800,000
California Property	\$1,000,000	\$1,200,000
Apportionment %	100%	66.66%
 <u>Payroll Factor</u>		
MEA Payroll	\$800,000	\$ 800,000
California Payroll	\$800,000	\$1,000,000
Apportionment %	100%	80%
 Average Apport. % (Property + Payroll Factors)/2	 100%	 73.33%
 Apportioned Business Income	 \$228,000	 \$250,000
MEA Income	\$228,000	\$183,333

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16554 Apportioning for Personal Income Tax Taxpayers

The following examples show the application of the apportioning rules to personal income tax taxpayers.

Example: Ray Smith is vice president of an S corporation that has two locations, one within the MEA and one outside the MEA. Eighty percent (80%) of the S corporation's business is attributable to the MEA. (**NOTE:** This percentage was determined by the S corporation, using Worksheet II from the FTB 3808 Business Booklet, at the time the S corporation return was prepared). Ray divides his time equally (50% & 50%) between the two offices of the S corporation.

Mary Smith (Ray's spouse) works for the S corporation at its office located in the MEA.

Ray and Mary Smith have the following 1999 items of California income and expense:

Ray's salary from the S corp.	\$100,000
Mary's salary from the S corp.	75,000
Interest on savings account	1,000
Dividends	3,000
Schedule K-1(100S) from the S corp.	
Ordinary income	40,000
MEA business expense deduction	(5,000)*
Ray's unreimbursed employee expenses from Schedule A	(2,000)

*The MEA business expense deduction is a separately stated item on Schedule K-1 (100S).

The Smith's MEA income is computed as follows:

Ray's MEA salary (\$100,000 x 50%)	\$50,000
Mary's MEA salary (\$75,000 x 100%)	75,000
Pass-through ordinary income from the S-Corp. (\$40,000 x 80%)	32,000
MEA business expense deduction from the S-Corp.	(5,000)
Ray's unreimbursed employee business expenses (2,000 x 50%)	<u>(1,000)</u>
Total MEA income	\$151,000

Ray and Mary must compute the tax on the total MEA income of \$151,000 (as if it represents all of their income). Using the tax rate schedule for the filing status *married filing joint*, the 1999 tax on

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\$151,000 is \$10,659. The \$10,659 is the first limitation on MEA credits for the 1999 tax year. The second limitation on the credits is the *net tax* on all income.

NOTE: The standard deduction and personal or dependency exemptions are not included in the computation of MEA income since they are not related to trade or business activities.

Example: John Doe is the President and shareholder of an S corporation with one location operating entirely within the MEA. John receives a salary of \$50,000 from the corporation. John's CA AGI is made up of the following items:

S corporation salary	\$50,000
Interest on Savings Account	5,000
Dividends	2,000
Capital Gain	10,000
S corp. ordinary loss from Schedule K-1(100S)	<u>(60,000)</u>
CA AGI	\$7,000

John's MEA income is computed as follows:

S corporation salary	\$50,000
S corporation ordinary loss	<u>(60,000)</u>
Total MEA income/(loss)	\$(10,000)

John's MEA hiring credit from Schedule K-1 (100S) totals \$3,000. Since John has negative MEA income, he cannot use the MEA hiring credit. The hiring credit claimed cannot exceed the amount of tax on the MEA business income in any year. However, carryover of the unused credit would be allowed.

16560 S Corporations

References 17053.47(f); 23622.8(e); 23803(a)(1)(A); 23803(a)(1)(F)

An S corporation's hiring credit may reduce the MEA tax at both the corporate and shareholder levels. However, the S corporation may only use one-third (1/3) of the credit to reduce the tax on the S corporation's MEA income.

One hundred percent (100%) of the MEA credit is passed through to the S corporation shareholders. The full amount of the credit is reported on Schedule K (100S) and passed through to the shareholders on Schedules K-1 (100S).

The wage reduction for the S corporation is equivalent to the 1/3 credit amount. The wage reduction for the shareholders is 100% of the credit amount, equal to the amount of credit passing through to them.

Example: An S corporation computes a \$3,000 hiring credit. The S corporation's credit is \$1,000 and the wage reduction is \$1,000. The \$3,000 credit is passed through to the S corporation's shareholders, and the wage reduction recognized by the shareholders is \$3,000.

16600 Credit Usage & Carryover

EDAM 16610	Credit Will Not Reduce Certain Taxes
EDAM 16620	Credit Recapture
EDAM 16621	Non-Seasonal Employees
EDAM 16622	Seasonal Employees
EDAM 16623	Credit Recapture – Exceptions
EDAM 16624	Change in the Form of the Trade or Business

The total amount of the MEA credit, including any credit carryover from prior years, that may reduce the "net tax"/"tax" for the taxable year, shall not exceed the amount of tax imposed on the taxpayer's business income attributable to the MEA, determined as if that income represented all of the income of the taxpayer.

The portion of the credit that exceeds the "net tax"/"tax" for the taxable year, may be carried over and added to the credit, if any, in the following year. The credit may be carried over to succeeding years, until it is exhausted.

If a credit carryover remains after the MEA has expired, is no longer binding, or becomes inoperative, the MEA shall be deemed to remain in existence for purposes of computing the taxpayer's business income attributable to the MEA.

Example: A taxpayer has a \$4,900 MEA hiring credit. Tax imposed on MEA business income is \$4,700, and the taxpayer's overall "net tax"/"tax" is \$4,000. The taxpayer would be eligible to claim a \$4,000 maximum hiring credit.

Total MEA hiring credit	\$4,900
Tax on MEA income	\$4,700
<u>First limitation:</u>	
Lesser of total credit or tax on MEA income	\$4,700
<u>Second limitation:</u>	
Lesser of tax on MEA Income or "net tax"/"tax"	\$4,000
Maximum credit allowed:	
Lesser of <i>MEA tax limitation</i> or " <i>net tax"/"tax" limitation</i>	<u>\$4,000</u>
Total hiring credit	\$4,900
Maximum credit allowed	<u>\$4,000</u>

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Carryover

\$ 900

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16610 Credit Will Not Reduce Certain Taxes

The MEA hiring credit cannot reduce the:

- Minimum franchise tax (corporations, limited partnerships, limited liability partnerships, LLCs, and S corporations);
- Annual tax (partnerships, LLCs classified as partnerships and Q-Subs).
- Built-in gains tax (S corporations);
- Excess net passive income tax (S corporation);
- Alternative minimum tax (corporations, exempt organizations, individuals and fiduciaries); or
- Regular tax below tentative minimum tax.

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16620 Credit Recapture

References 17053.47(d)(1)(A); 17053.47(d)(1)(B); 17053.47(d)(3); 23622.8(d)(1)(A); 23622.8(d)(1)(B); 23622.8 (d)(3)

16621 Non-Seasonal Employees

Recapture of the hiring credit is required if the employee is terminated before the end of the longer of the following two periods:

- The first 270 "days of employment" (whether or not consecutive); or
- Ninety (90) "days of employment" plus 270 calendar days.

To recapture the credit, the taxpayer must add to the current year's tax the amount of credit claimed for the year of termination, as well as all prior year credit claimed for the terminated employee.

16622 Seasonal Employees

For taxable years beginning on or after January 1, 1998, for seasonal employees, the taxpayer must recapture the amount of the credit if employment is terminated before the completion of 270 "days of employment" during the 60-month period beginning the day the employee commences employment with the taxpayer except as subsequently discussed.

To recapture the credit, the taxpayer must add the amount of credit previously claimed in all years to the tax for the tax year that includes the 60th month of employment.

A "day of employment" includes any day the employee was paid to work, regardless of whether the employee actually worked (including paid holidays, sick days, and vacation days).

NOTE: Any increase in tax, due to credit recapture, cannot be offset by the current year hiring credit.

16623 Credit Recapture – Exceptions

References 17053.47(d)(2)(A); 17053.47(d)(2)(B); 23622.8(d)(2)(A); 23622.8(d)(2)(B)

For both regular and seasonal employees, the credit recapture will not apply if the termination was:

- Voluntary on the part of the employee;
- Caused by the employee becoming disabled;
- Due to employee misconduct;
- Due to a substantial reduction in business; or
- In order to enable other qualified employees to be hired, creating an increase in the number of qualified employees and the hours of employment.

16624 Change in the Form of the Trade or Business

References 17053.47(d)(2)(C); 23622.8(d)(2)(C)

The employment relationship between the taxpayer and an employee is not treated as terminated by reason of a mere change in the form of conducting the trade or business. If the employee continues employment in that trade or business and the taxpayer retains a substantial interest in that trade or business, the employee is not treated as terminated. In addition, transactions in which IRC § 381(a) applies will not trigger recapture if the employee continues to be employed by the acquiring corporation.

16700 Record Keeping Requirements

For each qualified employee, documentation should be kept showing the following:

- Employee name
- Date employee was hired
- Number of hours the employee worked for each month of employment
- Wage rate paid for each month of employment
- Schedule calculating the hiring credit
- Overtime hours
- Location where services were performed
- Date employee was terminated, and reason why