State of California
Franchise Tax Board

New Employment Credit Report

Economic and Statistical Research Bureau

New Employment Credit Report

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

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. 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 Geographic Area (DGA),
- Receive a Tentative Credit Reservation (TCR) from the Franchise Tax Board (FTB) (within 30 days of complying with the 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 (or $10 for a Pilot Area) and 350 percent of minimum wage. At the time the NEC was chaptered the 2014 qualifying wage range, excluding pilot areas, was between $12 and $28 an hour. This increased to $13.50 and $31.50 with a July 1, 2014 increase in minimum wage. 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.

A qualified taxpayer:

- Is an employer engaged in a trade or business within a designated DGA,
- 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, and
- 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 unemployed for the six months immediately preceding employment, or
- Is a veteran who has not been employed since separation from service, or
- Is a recipient of the federal earned income tax credit for the previous taxable year, or

Is an ex-offender immediately preceding employment.

Following the enactment of AB 93 and SB 90, the Franchise Tax Board publicized the availability of the New Employment Credit via various outreach efforts including:

- Making presentations at 80 tax practitioner events.
- Distributing informational brochures at nearly 90 small business fairs throughout the State.
- Publishing articles in the FTB's Tax News online newsletter.
- Implementing an interactive website with "Quick Facts" and FAQs, as well as online mapping, reservation, and employment certification tools.

FTB Statutory Reporting Requirements

The FTB is required to provide an annual report, by no later than March 1, to the Joint Legislative 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 is based on 2014 return data processed as of January 2016.

Initial Observations

As with any new tax program, there is a learning curve associated with the program's implementation. Estimating the size of this curve prior to implementation is a challenge which at times results in large variances between what the estimated impact will be versus the actual impact.

Based on return data available at the time of this report, $3.9 million of NEC credits were claimed for the 2014 tax year. This amount is well short of initial program estimates implying that either the learning curve is particularly steep for the NEC and/or other factors are working to limit credit use. The FTB believes the following factors may be curtailing the use of NEC credits in the short term:

- <u>The learning curve</u>: Any new program will have procedural requirements and filing processes that are unfamiliar to taxpayers. The reservation process is new to the hiring credit genre and it is believed that many small businesses may not be aware of this requirement. New programs are often associated with more frequent taxpayer return errors. In some instances taxpayers who would otherwise qualify for the credit may not be aware of the program's existence despite the numerous outreach efforts outlined above.

- Other credits in lieu of the NEC are being utilized: For instance, the enterprise zone hiring credit was targeted to be replaced in part by the NEC credit. Taxpayers who have both credits available to claim in a tax year will tend to claim the enterprise zone credits first as they will be phased out sooner.
- Claiming without a reservation: There is some evidence that of those claiming the NEC, not all made reservations or met other requirements and thus were not qualified to take the credit.
- Reservations without claims: Nearly $15 million in credit was reserved in 2014, significantly more than the amount claimed. It is not clear why credits actually claimed on tax returns were so much lower than reservations. One possible reason is that some taxpayers may have unexpectedly failed to fulfill the requirement that they increase total employment over the previous year. If in the future taxpayers can claim a greater portion of the credits they reserve, there could be an increase in usage without any statutory changes to the program.

For the reasons stated above, and because the NEC program is new and it is not yet clear what taxpayer behavior patterns will be, FTB staff advises caution in making statutory changes to the current program.

Should these and other unknown issues be playing a role in dampening NEC use, there could be a discernible increase in NEC credits claimed in the next few years as taxpayers work through these growing pains. In summary, utilization will likely increase on its own without policy changes.

Credits Claimed: Estimates and Actual

At the time AB 93 was chaptered, the FTB had estimated that $22 million in credits would be claimed for fiscal year 2014-15. For purposes of this report, the FTB is treating returns filed for the 2014 tax year as impacting the 2014-15 fiscal year. During the 2014 calendar year, $15 million in credit reservations were made.[1] As of the date of this report, taxpayers have reported $3.9 million in credits claimed on 2014 tax year returns. These totals do not include all fiscal year filers. Based on preliminary reviews of credits claimed, there are indications that some of these credits may be disallowed.

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 the program has not been in place long enough to identify patterns which might pinpoint specific reasons for the shortfall in credits claimed, the FTB has identified program features where changes might encourage taxpayers to utilize the program above current levels:

- Change geographic limitations: Current law stipulates that DGA's are census tracts that have the highest unemployment and highest poverty in the State, former Enterprise Zones,

[1] The credit is predicated on whether the qualified employer has a net increase in the total number of full-time employees employed in California. Therefore, the number of reservations may not be reflective of the actual credit taken.

and former Local Agency Military Base Recovery Areas (LAMBRAs). Expanding this requirement to include areas that currently do not qualify would increase credit use.

- Change eligibility requirements: 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.
- Change range of wages qualifying: 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. In a pilot area, qualified wages are wages paid or incurred that exceed $10 an hour, but do not exceed 350 percent of minimum wage. As of 2016 the minimum wage is $10 in California so the qualifying wage range, excluding pilot areas, is between $15 and $35 an hour. Expanding the range of wages that qualify for the credit would promote credit use.
- Drop reservation requirement (or streamline reservations): Under current law an employer must receive a TCR from the FTB within 30 days of complying with the EDD new hire reporting requirement to qualify an employee for the credit. 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.
- Expand/increase education and outreach: In addition to the program features listed above, additional outreach efforts could be undertaken to increase participation.

As the Legislature considers options for increasing claims under the NEC program, it may wish to keep in mind the credit's goal of incentivizing net new hiring and avoid some of the windfall provisions that were contained in the prior Enterprise Zone Hiring Credit (EZ). Under the EZ program, a net addition in employment was not required of the employer, credit was available to types of businesses unlikely to be incentivized by the credit, and taxpayers could take advantage of the credit as an afterthought if it hired an eligible employee—regardless of whether the employer was aware of the credit at the time of hire.