SUBJECT: Small Business Compliance Credit

SUMMARY

This bill would, under the Personal Income Tax Law (PITL) and the Corporation Tax Law (CTL), allow a credit to a qualified small business for each man hour spent on compliance on state regulations and law.

RECOMMENDATION - NO POSITION.

REASON FOR THE BILL

The reason for the bill is to reduce the cost incurred by small businesses to comply with state laws and regulations.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for each taxable year beginning on or after January 1, 2017.

FEDERAL/STATE LAW

Current state and federal laws generally allow taxpayers engaged in a trade or business to deduct all expenses that are considered ordinary and necessary in conducting that trade or business.

Existing state and federal laws provide various tax credits designed to provide tax relief for taxpayers who incur certain expenses (e.g., child adoption) or to influence behavior, including business practices and decisions (e.g., research credits or economic development area hiring credits). These credits generally are designed to provide incentives for taxpayers to perform various actions or activities that they may not otherwise undertake.

THIS BILL

For each taxable year beginning on or after January 1, 2017, this bill would, under the PITL and CTL, allow a tax credit to a qualified small business in an amount equal to $25 per each man-hour spent on compliance with state laws and regulations.

The bill would define the following:

- “Compliance with state laws and regulations” means the adherence to laws, regulations, guidelines, and specifications relevant to the taxpayer’s business and includes, but is not limited to, preparation for, and the providing of, mandatory training for employees, modification of the business premises, and providing required information regarding employee safety.
• “Qualified small business” means a business that:
  o Is independently owned and operated.
  o Is not dominant in its field of operation.
  o Has fewer than 100 employees.
  o Averages annual gross receipts of $15,000,000 or less over the previous three taxable years.

Unused credits could be carried over for seven years or until exhausted.
The provisions of Section 41\(^1\) would be inapplicable to the credit allowed by this section.

IMPLEMENTATION CONSIDERATIONS

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

If enacted by the legislative deadline in September, this bill would be effective January 1, 2017, and would require taxpayers to have kept track of man-hours in order to receive the credit. Because it is unlikely that taxpayers would be keeping track of how many hours they spent “complying with laws and regulations,” most would miss the opportunity to take full advantage of this credit. If this is contrary to the author’s intent, it is recommend the bill be amended to be effective on January 1, 2018 or later, in an effort to give taxpayers time to comply with the requirements necessary to qualify for the credit.

This bill uses phrases that are undefined, i.e., “independently owned and operated,” “man-hour,” “not dominant in its field of operation,” and “compliance with state laws and regulations.” The absence of definitions to clarify these phrases could lead to disputes with taxpayers and would complicate the administration of this bill. For clarity and ease of administration, it is recommended the bill be amended to clearly define these phrases.

The bill specifies that to qualify as a “qualified small business” the business must “have fewer than 100 employees.” However, the bill fails to specify when the 100 employee count must not be exceeded. It is recommended the bill be amended to specify when the employee count should occur or if the business can never exceed 100 employees during the tax year to keep its qualification as a small business. The bill also specifies a “qualified small business” averages annual gross receipts of $15 million or less over the previous three taxable years. How does this apply to new businesses or recently moved from out of state businesses? What is the measure of “gross receipts” for the purposes of this section? Only those “gross receipts” reportable to this state?

\(^1\) Under Revenue and Taxation Code section 41, legislation that would create a new tax credit is required to include specific goals, purposes, objectives, and performance measures to allow the Legislature to evaluate the credit’s effectiveness.
LEGISLATIVE HISTORY

Research of California legislation found no legislation similar to the provisions of this bill.

OTHER STATES’ INFORMATION

Review of Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York laws found no comparable tax credit. These states were selected and reviewed due to their similarities to California's economy, business entity types, and tax laws.

FISCAL IMPACT

The department’s costs to implement this bill have yet to be determined. As the bill moves through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue loss:

<table>
<thead>
<tr>
<th>Estimated Revenue Impact of AB 831</th>
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</thead>
<tbody>
<tr>
<td>As Introduced on February 16, 2017</td>
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<tr>
<td>Assumed Enactment After June 30, 2017</td>
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<tr>
<td>($ in Billions)</td>
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<tr>
<td>2017-18</td>
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<td>- $18</td>
</tr>
</tbody>
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This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

Based on data from the US Small Business Administration and the FTB, there are an estimated 3.2 million small businesses that would qualify for the credit in 2017. Due to the timing of this bill, it is assumed that 80 percent, or 2.5 million businesses, would claim the credit. Based on available research, it is assumed that each eligible business would employ the average equivalent of one full-time employee to work on state compliance laws and regulations. It is assumed the employee would work an average of 1,300 hours annually. This would result in approximately 3.3 billion hours spent on qualified compliance activities. The credit is computed at $25 per hour, resulting in estimated credits generated of $80 billion in 2017. It is assumed that 10 percent, or $8 billion, of the credit will be used in the year generated. It is assumed that taxpayers would utilize some of the remaining credits over the next seven years, or until expired. However, taxpayers would continue to generate new credits each year thus accumulating a reserve of credits for future use.

The calendar year estimates are converted to fiscal years and then rounded to arrive at the amounts shown in the table above.
SUPPORT/OPPOSITION

Support:  None provided.

Opposition:  None provided.

ARGUMENTS

Proponents:  Some may argue that this bill would provide much need tax relief to small businesses who must pay wages to employees to comply with overly complicated state laws and regulations.

Opponents:  Some may argue that this bill would inappropriately allow small businesses to claim multiple benefits on the same wages paid to employees.

POLICY CONCERNS

This bill lacks a sunset date.  Sunset dates generally are provided to allow periodic review of the effectiveness of a tax benefit by the Legislature.

Because wages paid to employees are deductible under current law and may also be eligible under another provision of state tax law for a wage credit, this bill would allow taxpayers to claim multiple tax benefits for the same item of expense.

Generally, credits are limited as a percentage of amounts paid or incurred.  This bill would allow a twenty five dollar credit per man-hour regardless of the amount of the wage paid.

This bill fails to limit the amount of the credit that may be taken.  Credits that could potentially be quite costly are sometimes limited either on a per-project or per-taxpayer basis.

LEGISLATIVE STAFF CONTACT

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