

Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author: Fuller Analyst: Jessica Deitchman Bill Number: SB 661
Related Bills: See Legislative History Telephone: 845-6310 Introduced Date: February 17, 2017
Attorney: Bruce Langston Sponsor: _____

SUBJECT: Modify the New Employment Credit

SUMMARY

This bill would, under the Personal Income Tax Law (PITL) and the Corporation Tax Law (CTL), modify the New Employment Credit (NEC).

RECOMMENDATION – NO POSITION

REASON FOR THE BILL

The reason for the bill is to modify the NEC in ways that would allow more taxpayers to claim the credit.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2017, and before January 1, 2031.

FEDERAL/STATE LAW

For taxable years beginning on or after January 1, 2014, and before January 1, 2021, current state law allows a NEC that is available to a qualified taxpayer that hires a qualified full-time employee, has an overall net increase in employment, and pays or incurs qualified wages attributable to work performed by the qualified full-time employee in a designated census tract¹ or former Enterprise Zone (EZ).² The qualified taxpayer must receive a tentative credit reservation from the Franchise Tax Board (FTB) for that qualified full-time employee within 30 days of complying with the Employment Development Department’s new hire reporting requirements,³ in a form and manner prescribed by the FTB (currently via an online reservation system). To obtain a tentative credit reservation a taxpayer provides information to the FTB, including the name, social security number, the start date of employment, the qualified full-time

¹ Would mean a census tract within the state that is determined by the Department of Finance to have a civilian unemployment rate that is within the top 25 percent of all census tracts within the state and has a poverty rate within the top 25 percent of all census tracts within the state.

² “Former enterprise zone” means an enterprise zone designated as of March 1, 2012, and any expansion of an enterprise zone prior to December 31, 2012, as in effect on December 31, 2012, excluding any census tract within an enterprise zone that is identified by the Department of Finance (DOF) as a census tract with the lowest civilian unemployment and poverty.

³ As provided in Section 1088.5 of the Unemployment Insurance Code.

employee's pay rate, the qualified taxpayer's gross receipts from the previous taxable year, and whether the qualified full-time employee is a resident of a targeted employment area. Receipt of a tentative credit reservation does not constitute a determination by the FTB with respect to any of the requirements regarding a qualified taxpayer's eligibility for the NEC.

A qualified taxpayer is required to provide the FTB with an annual certification with respect to each qualified full-time employee hired in a previous taxable year, on or before the 15th day of the 3rd month of each taxable year.

A qualified taxpayer means a person or entity engaged in a trade or business within a designated census tract or former EZ that during the taxable year pays or incurs qualified wages. With the exception of a qualified taxpayer that is a small business, an otherwise qualified taxpayer is ineligible for the hiring credit if they provide services as described in the following codes or sectors of the North American Industry Classification System (NAICS):

- Code 561320 Temporary Help Services
- Sector 44-45 Retail Trade
- Code 711110 Theater Companies and Dinner Theaters
- Code 722511 Full-Service Restaurants
- Code 722513 Limited-Service Restaurants
- Code 722514 Cafeterias, Grill Buffets, and Buffets
- Code 722515 Snack and Nonalcoholic Beverage Bars
- Code 713210 Casinos (except Casino Hotels)
- Code 721120 Casino Hotels
- Code 722410 Drinking Places (Alcoholic Beverages)

If a qualified taxpayer relocates to a designated census tract or former EZ from another location within the state, hiring credits would only be available if each employee at the previous location or locations is provided a written offer of employment with comparable compensation at the new location, unless the taxpayer is a small business.⁴

A qualified full-time employee means an individual who meets all of the following requirements:

- Performs at least 50 percent of his or her services for the qualified taxpayer during the taxable year in a designated census tract or former EZ.
- Receives starting wages that are at least 150 percent of the minimum wage.
- Is hired by the qualified taxpayer on or after January 1, 2014.

⁴ "Small business" means a trade or business that has aggregate gross receipts, less returns and allowances reportable to this state, of less than \$2,000,000 during the previous taxable year. For a partnership or S-corporation the gross receipts limitation shall be applied to the partnership or the S-corporation and to each partner or shareholder. For taxpayers required to be included in a combined report, the gross receipts limitation shall be applied to those taxpayers as reported or authorized to be reported in a combined report.

- Is hired by the qualified taxpayer after the date the DOF determines that the census tract is a designated census tract or that the census tracts within a former EZ are not census tracts with the lowest civilian unemployment and poverty.

A qualified full-time employee must satisfy either of the following conditions:

- Is paid qualified wages by the qualified taxpayer for services not less than an average of 35 hours per week.
- Is a salaried employee and was paid compensation during the taxpayer year for full-time by the qualified taxpayer.

Upon commencement of employment with the qualified taxpayer, the qualified employee must satisfy any of the following conditions:

- Was unemployed^{5,6} for the six months immediately preceding commencement of employment with the qualified taxpayer.
- Is a veteran that has not been employed since separation from service in the Armed Forces of the United States.
- Was a recipient of the federal earned income tax credit (EITC) for the previous taxable year.
- Was an ex-offender immediately preceding commencement of employment with the qualified taxpayer.

“Qualified wages” means those wages that meet both of the following requirements:

- That portion of wages paid or incurred by the qualified taxpayer during the taxable year to each qualified full-time employee that exceeds 150 percent of minimum wages, but does not exceed 350 percent of minimum wage.
- Wages paid or incurred during the 60-month period beginning with the first day the qualified full-time employee commences employment with the qualified taxpayer.

The amount of the NEC allowable for a taxable year is equal to the product of the tentative credit amount for the taxable year and the applicable percentage for that taxable year.

- The “tentative credit amount” for the taxable year is equal to the product of the “applicable credit percentage” for each qualified full-time employee and the qualified wages paid by the qualified taxpayer during the taxable year to the qualified full-time employee. The “applicable credit percentage” for all calendar years is 35 percent.

⁵ An individual is “unemployed” for any period of time in which an individual is not in receipt of wages subject to state withholding, and not self-employed, and not a registered full-time student at a high school, college, university, or other postsecondary educational institution for that period.

⁶ In the case of a an individual that has completed a program of study at a college, university, or other postsecondary educational institution, received a baccalaureate, postgraduate, or professional degree, and was unemployed for six months immediately preceding employment with the qualified taxpayer, that individual must have completed that program of study at least 12 months prior to the individual’s commencement of employment with the qualified taxpayer.

- The “applicable percentage” for a taxable year is equal to a fraction, the numerator of which is the net increase in the total number of full-time employees in the state during the taxable year, determined on an annual full-time equivalent basis, as compared with the total number of full-time employees in the state during the base year, the denominator is the total number of qualified full-time employees in the state during the taxable year. The applicable percentage may not exceed 100 percent.
 - “Base year” means the 2013 taxable year, except in the case of a qualified taxpayer who first hires a qualified full-time employee in a taxable year beginning on or after January 1, 2015, then the base year would mean the taxable year immediately preceding the taxpayer year in which the qualified full-time employee was first hired.
- The “net increase in full-time employees” is determined as follows:
 - On an annual full-time equivalent basis, by subtracting the total number of full-time employees employed in the base year by the qualified taxpayer from the total number of full-time employees employed in the current taxable year by the qualified taxpayer.
 - For taxpayers who first commence doing business in this state during the taxable year, the number of full-time employees for the base year is zero.

Additionally, current law allows the Governor’s Office of Business and Economic Development (GO-Biz) to designate up to five designated pilot areas within designated census tracts and economic development areas that allow a lower wage threshold for qualifying as qualified wages. The portion of wages of a qualified employee employed in a designated pilot area that is considered to be qualified wages is that portion of wages paid or incurred by a qualified taxpayer that is between \$10/hr and 350 percent of the state minimum wage, instead of the portion paid or incurred that is between 150 percent and 350 percent of the state minimum wage for qualified employees employed in designated census tracts or economic development area but outside of the designated pilot areas.

The designation of a designated pilot area may last for a period of four calendar years and may be extended by the GO-Biz for up to three additional calendar years, not to extend beyond December 31, 2020. The designation of the designated pilot areas and the extension of the designation is at the sole discretion of the GO-Biz and is not subject to administrative or judicial review.

The FTB is required to do the following:

- Approve a tentative credit reservation request with respect to a qualified full-time employee hired during the calendar year.
- Determine the aggregate tentative reservation amount and the aggregate small business tentative reservation amount for a calendar year.
- Expeditiously process tentative credit reservation requests regarding qualified full-time employees that reside in a targeted employment area.

- Provide a searchable database for each taxable year beginning on or after January 1, 2014, and before January 1, 2019, that includes the employer names, amount of hiring tax credit claimed, and the number of new jobs created.
- Provide to the Joint Legislative Budget Committee an annual report regarding the amount of credits claimed during the previous fiscal year, by March 1, of each year.

The credit claimed by a qualified taxpayer in regards to a qualified full-time employee may be recaptured and assessed in the same manner as a mathematical error for the taxable year of termination if the qualified full-time employee is terminated by the qualified taxpayer at any time during the first 36 months, after commencing employment with the qualified taxpayer, unless any of the following occur:

- The qualified full-time employee voluntarily leaves the employment of the qualified taxpayer.
- The qualified employee becomes disabled and unable to perform the services of employment.
- The qualified employee was terminated for misconduct.
- The termination was due to a substantial reduction in the trade or business operations of the taxpayer, including reductions due to seasonal employment.
- The terminated qualified employee is replaced by other qualified full-time employees so as to create a net increase in both the number of employees and the hours of employment.

The NEC may only be claimed on a timely filed original return of the qualified taxpayer.

Generally tax credits allowed under the PITL or the CTL are precluded from reducing tax (regular tax) below tentative minimum tax, except as provided in the statute. The NEC is one of the credits precluded from reducing regular tax below the tentative minimum tax.

THIS BILL

This bill would reduce by four taxable years the availability of the existing NEC by replacing 2024 with 2017, make a similar change to the existing sunset date, and allow for taxable years beginning on or after January 1, 2017, and before January 1, 2031, the NEC modified as follows:

- Modify the definition of a “qualified employee” to eliminate the requirement that they be paid at least 150 percent of minimum wages, effectively allowing an employee to be paid any wage.
- Provide a new category of “qualified employees” to include an employee that upon commencement of employment is a resident of a county that has an unemployment rate that is at least 150 percent of the statewide average or a county that has a poverty rate that is at least 125 percent of the statewide average.
- Modify the definition of “qualified employee” to include an employee that upon commencement of employment was eligible to be a recipient of the credit allowed under Section 32 of the Internal Revenue Code, relating to earned income, for the previous taxable year.

- Modify the definition of a “qualified taxpayer” to include two previously-excluded types of employers.
 - Employers that provide retail trade services, as described in Sector 44-45 of the NAICS published by the United States Office of Management and Budget, 2012 edition.
 - Employers that are primarily engaged in providing food services, as described in Code 711110, 722511, 722513, 722514, or 722515 of the NAICS published by the United States Office of Management and Budget, 2012 edition.
- Modify the way the credit is calculated to include all wages paid to qualified employees that do not exceed 350 percent of minimum wage.
- Remove all provisions relating to a “pilot area.”
- Allow small businesses’ base year to be zero for small businesses⁷ that are located in a county that has an unemployment rate that is at least 150 percent of the statewide average or a county that has a poverty rate that is at least 125 percent of that statewide average.
 - “Small business” means a trade or business that has aggregate gross receipts, less returns and allowances reportable to this state, of less than \$2,000,000 during the previous taxable year.

The bill would add the NEC to the list of credits allowed to reduce tax below tentative minimum tax allowed under the PITL and CTL.

All reporting requirements for the FTB would remain the same in this bill as current law, with a sunset date of taxable years beginning before January 1, 2031.

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.

The bill fails to make date changes to the base year for the new NEC. As a result, employers will need to keep records of their employees from the 2013 tax year to calculate the credit. If this is contrary to the author’s intent, the bill should be amended.

The bill lacks transition language between the two credits. For example, if a taxpayer hires a qualified employee in 2016, it is unclear if the wages would be included as part of the old credit or the new credit and which 60-month commencement of employment date would apply. For clarity, the bill should be amended.

⁷ As of January 1, 2018.

This bill would result in duplicated Revenue and Taxation Code section numbers allowing a NEC that, while similar, is not the same. This could result in taxpayer confusion and disputes between taxpayers and the department. It seems the author intends to extend the NEC with some modification. For clarity and ease of administration, the author may wish to recast the credit provisions in the existing NEC to eliminate the duplicated section numbers.

Further, the bill fails to modify the language relating to when and how DOF designates and re-designates census tracts. To avoid confusion between taxpayers and the department, it is recommended the bill be amended.

If enacted, the bill would remain unsigned until September or October of 2017. This bill currently has an operative date of January 1, 2017 and requires that all employers receive a reservation for employees hired within 30 days from the date of hire. The department would be unable to complete the required updates to the existing NEC reservation system in order for certain provisions in this bill to be operative with a retroactive operative date. In addition, the department would have developed the forms and instructions for the 2017 taxable year. Thus, the department may incur additional costs to develop additional tax forms and instructions in the short time frame necessary to ensure they are available for taxpayers. To alleviate these concerns, and allow taxpayers the opportunity to use the credit, the author may wish to change the operative date to taxable years beginning on or after January 1, 2018, or later.

The bill would allow a new type of “qualified employee” to include one that “is a resident of a county that has an unemployment rate that is at least 150 percent of that statewide average or a county that has a poverty rate that is at least 125 percent of the statewide average.” Additionally, the bill would allow a small businesses’ base year to be zero for “small businesses that are located in a county that has an unemployment rate that is at least 150 percent of the statewide average or a county that has a poverty rate that is at least 125 percent of that statewide average.” However, the bill fails to specify how the determination would be made, when it would be made, for how long the designation would be valid, and who would make the determination. Because the unemployment rate of a specific counties is not something that may be readily available to taxpayers or the department, it is recommended the bill be amended to specify how and when this information would be made available.

It is unclear how a qualified taxpayer or the FTB would know and document whether an individual was eligible for the federal earned income tax credit as of the date the individual commences employment with the qualified taxpayer.

LEGISLATIVE HISTORY

AB 1629 (Maienschein, et al., 2017/2018) would allow a credit to a qualified employer who employs a qualified employee and pays the qualified employee a wage that exceeds the minimum wage during the taxable year. The credit would have been in an amount equal for the difference between the special minimum wage that may be paid to a qualified employee and the minimum wage. AB 1629 was introduced on April 18, 2017.

SB 507 (Hueso, 2017/2018) would expand eligibility for the NEC by modifying the definition of qualified employees. SB 507 was introduced on February 16, 2017.

SB 1216 (Hueso, 2015/2016) would have allowed a credit to a qualified employer who employed a qualified employee who was an ex-felon. SB 1216 failed to pass out of the house of origin by the constitutional deadline.

AB 1404 (Grove, 2015/2016) would have allowed a credit to a qualified employer who employs a qualified employee and pays the qualified employee a wage that exceeds the minimum wage during the taxable year. The credit would have been in an amount equal for the difference between the special minimum wage that may be paid to a qualified employee and the minimum wage. AB 1404 failed to pass out of the house of origin by the constitutional deadline.

SB 90 (Galgiani and Canella, Chapter 70, Statutes of 2013), modified AB 93 as chaptered on July 11, 2013. Specifically, SB 90, for purposes of the NEC, modified the definition of qualified employee, excluded sexually oriented businesses from the definition of qualified taxpayer and small business, and modified the defined geographical area that the hiring credit may be generated in.

AB 93 (Assembly Committee on Budget, Chapter 69, Statutes of 2013), repealed the geographically targeted economic development area tax incentives and the New Jobs Tax Credit under the PITL and CTL, created a NEC, established the California Competes Tax Credit (CCC) Committee, and created the CCC under the PITL and CTL.

OTHER STATES' INFORMATION

Review of *Illinois, Florida, Massachusetts, Michigan, Minnesota, and New York* laws found no comparable tax credits. 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 and the implementation considerations are resolved, costs will be developed and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

This bill would result in the following revenue loss:

Estimated Revenue Impact of SB 661 As Introduced February 17, 2017 Assumed Enactment After June 30, 2017 (\$ in Millions)		
2017-18	2018-19	2019-20
- \$2.4	- \$8.9	- \$19.0

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 DOF, the U.S. Census Bureau, the Bureau of Labor Statistics, and the FTB, it is estimated that qualified employees would earn \$27 million in qualified wages. It is assumed that 15 percent of eligible employees would complete a full year of employment in the 2017 taxable year increasing to almost 97 percent in 2019. Applying a 35 percent credit for wages up to 350 percent of minimum wage results in a net credit generated of \$1.4 million in 2017, \$12.1 million in 2018, and \$28 million in 2019.

The estimated revenue loss is offset by approximately \$1 million dollars for the revenue gain resulting from the sunset of the existing NEC.

This estimate assumes 100 percent of the credit generated in 2017 would be used in the 2017 taxable year. In taxable years 2018 and forward, it is assumed 30 percent of the credit used would be used in the year generated and the remaining credit would be used over the next four years.

This results in a net revenue loss of \$400,000 in the 2017 taxable year, \$3.7 million in 2018, and \$13 million in 2019. The revenue loss is expected to grow by an estimated \$10 million per year through the 2022 taxable year when the credit is fully phased in.

The tax year estimates are converted to fiscal years and rounded to arrive at the amounts reflected in the above table.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some may argue that this bill would modify the NEC in ways that would encourage hiring of difficult-to-employ individuals.

Opponents: Some may argue that the expansion of this credit could further complicate the utilization of this credit.

LEGISLATIVE STAFF CONTACT

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