Credits and Incentives Briefing

A global and domestic credits and incentives network publication

September 2012

Dear Clients and Alumni,

This quarter our authors advance the theme of knowledge. Knowledge can prevent missed tax credit opportunities and can help your company increase its state tax credits. Also, knowledge of new disclosure laws can help protect your company from making sensitive information subject to public consumption.

Erin Bradley discusses California's enterprise zone program and how it relates to San Francisco's payroll expense tax exception. Even those knowledgeable in enterprise zone tax credits are often surprised at the number of potential categories employees may qualify under for purposes of the California enterprise zone program. Erin provides that the tax credit is not just for the typical disadvantaged employee living in a targeted area. A diligent employer asking just the right questions of its new employees can generate significant enterprise zone opportunities. Erin also explores how these enterprise zone opportunities can translate into additional benefits in San Francisco due to a payroll tax exception related to qualified employees located in San Francisco.

Scott Grisham also examines missed enterprise zone opportunities - in Texas. Scott informs us that commonly understood barriers to enterprise zone benefits may be worth a second look in Texas. Don't operate in a zone? Not hiring traditional "economically disadvantaged employees"? Not hiring new employees? Affirmative answers to these questions may not automatically preclude you from getting value from the Texas enterprise zone program.

Robert Rischmann asks "how much information is too much" with regard to Illinois' EDGE tax credit program. New disclosure rules raise the risk that any contract term in a negotiated EDGE agreement may be made publicly available. Sensitive or confidential information that may have been innocuously included in past agreements will need a fresh look. Taxpayers will have to walk a fine line of providing enough information to the state during negotiations to secure a tax credit, yet exercise caution not to provide information that they wouldn't want available to the public.

We continue to welcome your thoughts and input on any area that may be of interest to you or your company.

Regards,

Michael A. Harris
National Leader - Global and Domestic Credits and Incentives Network

Inside this issue:

KNOW THE CALIFORNIA EZ QUALIFYING CATEGORIES AND THE POTENTIAL OPPORTUNITIES IN SAN FRANCISCO

The hiring tax credit under California's Enterprise Zone program may be common knowledge. But, did you know that there are 16 categories of employees that will qualify an employer for the tax credit? Are you capturing all of them and maintaining the proper documentation? Did you know that a qualified employee can generate an EZ hiring tax credit *and* a reduction in the San Francisco payroll expense tax? Properly identifying, capturing, and claiming these opportunities provide a direct benefit to an employer.

Identify hiring credit categories, and document the credit

There are 16 categories under which an employee may qualify for the EZ hiring tax credit, which encourages taxpayers to hire people with barriers to employment. In order to identify, calculate, and increase the hiring tax credit available under the program, taxpayers located within an Enterprise Zone should look at all of the categories under which their employees may qualify.

Taxpayers who are located within a California Enterprise Zone may claim a tax credit for hiring employees who fall under one of the categories listed in California Revenue & Taxation Code section 23622.7. The category that is easiest to ascertain is that of the Targeted Employment Area (TEA) resident. Qualification of a TEA resident is determined by reviewing an employee's home address as of their date of hire. This may be done without ever talking directly to the employee, thus many employers prefer to stop at just this category. However, taxpayers who do not look beyond the TEA resident category are leaving

additional hiring tax credits on the table. Other qualifying categories include whether the employee is: eligible for benefits under certain federal programs, a "dislocated worker," disabled, an ex-offender, or a member of a federal "targeted group."

Identifying a qualifying employee is just the beginning. Employers must also implement and follow procedures to capture and document required data. Claiming a tax credit should involve an in-person interview with employees. During the interview process, all 16 EZ categories should be addressed to determine whether an employee qualifies under any of them. If the interviewer concludes that an employee may qualify, appropriate documentation must be provided by the employee to verify qualification. Regulations promulgated by the Department of Housing and Community Development specify what documents are required for each category. For example, an employee who qualifies as a Vietnam-era veteran must provide a copy of his or her discharge papers from the U.S. Military as proof of service.

To claim the EZ hiring tax credit, an employer must submit a voucher application to the applicable enterprise zone and, upon approval, retain the voucher provided by zone officials. A properly prepared application must include certain specified information and documentation for each employee and each employer. Although approved vouchers and supporting documents are not submitted with an employer's California tax return, such documents are generally required to be provided to the Franchise Tax Board (FTB) upon audit. As highlighted in the California Supreme Court's recent *Dicon Fiberoptics* decision, taxpayers may not rely on approved EZ vouchers and may be required to provide the FTB with the underlying application documentation support in order to sustain the tax credit on audit. For more information on the *Dicon* decision, please read our summary, available here.

Capturing the benefits of California's EZ hiring tax credit involves identifying all possible employee qualifying categories, maintaining a consistent hiring process inquiry for all new employees, and implementing application and document retention procedures. To increase the amount of potential tax credits, employers would be well served to have dedicated and experienced individuals maintain the procedures and implement specialized software as part of the process.

Using eligible EZ employees to qualify for the San Francisco payroll expense tax exemption

Businesses incur a 1.5% tax measured by their annual payroll expense paid to San Francisco employees. However, if an employee qualifies for the EZ hiring tax credit, a taxpayer located within the San Francisco zone may be able to reduce its payroll expense tax paid for that employee if all of the following conditions are met:

- The employee is a San Francisco resident;
- The employee was hired on or after June 30, 2008;
- At least 90% of the employee's services must be directly related to the conduct of the employer's trade or business located within an Enterprise Zone during the taxable year;

- At least 50% of the employee's services must have been performed in an Enterprise Zone during the taxable year; and

- The employee must qualify for the Enterprise Zone hiring tax credit under any category **other than** the TEA resident category.

The last requirement reinforces the critical role an employer's interview process plays in securing tax credits. Experienced interviewers must recognize that qualifying categories other than being a TEA resident must be explored during the interview process for San Francisco employees. The amount of payroll expense tax exemption varies from 10% to 100% and is taken over 10 years.

November Ballot Initiative affecting the San Francisco Payroll Expense Tax

Due to the perceived negative impact on creating jobs, there is an initiative on the November Ballot in San Francisco to institute a tax based on gross receipts and phase out the payroll expense tax. The tax would apply to a company's San Francisco receipts over $1 million and have rates from 0.075% to 0.65% depending on the industry. If passed, the gross receipts tax would be phased in over 5 years as the payroll expense tax is phased out.

Contact Info:

Erin Bradley, Director, San Francisco, (415) 498-5715
erin.r.bradley@us.pwc.com

MOST OFTEN MISSED OPPORTUNITIES UNDER THE TEXAS ENTERPRISE ZONE PROGRAM

Has your company passed on a review of the Texas Enterprise Zone Program because: (a) your company doesn't operate in a zone; (b) your company doesn't hire traditional economically disadvantaged employees; (c) your company isn't hiring new employees; or (d) there have been no changes to the program that would benefit your company? If so, your company is not alone in missing many overlooked aspects of the program. You may reconsider exploring the program after learning how significant benefits may be realized for activities not generally associated with enterprise zones.

Program purpose and benefits

Texas established its Enterprise Zone Program (TXEZ Program) to encourage job creation and capital investment in economically distressed areas of the state. Designated TXEZ Projects are eligible to apply for state sales and use tax refunds based on capital investment and the number of job positions created or retained, over a maximum project period of 5 years. The potential benefits are as follows.

Capital investment	Potential refund per job position created or retained	Maximum refund
$5,000,000 to $149,999,999	$2,500	$1,250,000
$150,000,000 to $249,999,999	$5,000	$2,500,000
$250,000,000 and up	$7,500	$3,750,000

The TXEZ program is not just for activity in a Zone

Although the name of the program may imply that a business must be in an enterprise zone to participate, this is not the case. An enterprise project may be located anywhere in the state. If a project is located within an enterprise zone, the business commits that 25% of its new employees will meet economically disadvantaged or enterprise zone residency requirements. If located outside of an enterprise zone, the business commits that 35% of its new employees will meet economically disadvantaged or enterprise zone residency requirements.

Meeting TXEZ program hiring requirements may not be as difficult as you think

A common misconception is that businesses don't qualify under the program because they do not hire enough "economically disadvantaged" or enterprise zone resident employees. In fact, "economically disadvantaged" is given a broader definition than one may think. In Section 2303.402 of the Texas Enterprise Zone Act, the definition of an economically disadvantaged individual may include, but is not limited to, an individual who:

(1) was unemployed for at least three months before obtaining employment with the qualified business;

(2) is a low-income individual, as defined by Section 101, Workforce Investment Act of 1998 (29 U.S.C. Section 2801(25));

(3) is an individual with a disability, as defined by 29 U.S.C. Section 705(20)(A);

(4) meets the current low income or moderate income limits developed under Section 8, United States Housing Act of 1937 (42 U.S.C. Section 1437f et seq.)

With the current economic downturn, a recent three month unemployment history may be common across a wide range of new employees. Other nontraditional qualifying employees may include recent college graduates as they may have been unemployed for at least three months before obtaining employment. Recent college graduates may also qualify as low income individuals or meet the current low income or moderate income limits, as these income limits are based on the 12 months prior to being employed with the qualified business.

The definition of a qualified "Zone" has been amended to include "low income block groups" and "distressed counties"

The Texas Enterprise Zone Act was amended September 1, 2005 by changing the definition of an Enterprise Zone to include: (1) a block group where 20% of its residents have income below 100% of the Federal poverty level; (2) areas designated by the Federal Government as a Renewal Community, (3) a Federal Empowerment Zone; (4) a Federal Enterprise Community; and (5) an area located in a distressed county.

This amendment increased the likelihood of a business hiring individuals from an enterprise zone, specifically those located in distressed counties. Any employee living within a distressed county would qualify as an enterprise zone resident.

Job retention may qualify under the TXEZ program

Although the initial intent of the TXEZ Program may have been to encourage job creation and capital investment in economically distressed areas, recent downturns in the economy have placed more focus on job retention. Amendments made to the Texas Enterprise Zone Act in 2007 modified the requirements of a qualified project to include one where the taxpayer can clearly demonstrate that:

- Employees will be permanently laid off;
- The business will close down permanently;
- The business will relocate out of state; or
- The business is able to employ disadvantaged employees (as defined above)

Increased participation has led to a more selective approval process

The state biennium beginning September 1, 2009, saw the largest increase in participation of the TXEZ Program since its inception, with well over 105 requests for designation being received by the fourth quarterly application round. By comparison, up to that point the state had not received more than 85 designation

requests in a biennium. This resulted in all available 105 designations being approved with approximately one year left in the biennium, causing some worthy projects to not be eligible due to timing.

The drastic increase in TXEZ Program participation resulted in certain policy changes effective for the biennium beginning September 1, 2011. Included in such changes were the following:

- TXEZ Project applications are scored and must have a minimum score of at least 60 points for consideration;
- The state may approve 12 designations each quarterly round during a biennium, with 9 additional designations being approved in any quarterly round at the state's discretion,
- Changes were made in the application scoring criteria that may include, but are not limited to:
    - Additional points for manufacturing businesses showing an increase in production capacity,
    - Additional points for manufacturing businesses showing a decrease in cost per unit,
    - Additional points for businesses with wages exceeding the county average wage,
    - Additional points for businesses located in economically distressed areas (high poverty levels)

These most recent changes have greatly reduced the number of TXEZ Project applications being submitted, with 25 applications submitted September 2011, 19 applications submitted December 2011, 12 applications submitted March 2012, and 7 applications submitted June 2012.

With the expanded definitions of a disadvantaged employee and an enterprise zone, it has been possible for many more businesses to qualify for job retention benefits. However, the increased administrative burdens highlight the need to exercise great care in navigating through the procedural hurdles to qualify and secure TXEZ program benefits.

Contact Info:

Scott Grishman, Director, Dallas, (214) 754-5022
scott.grishman@us.pwc.com

ILLINOIS EDGE: HOW MUCH INFORMATION IS TOO MUCH?

"The Department shall post on its website the terms of each Agreement entered into under this Act"

- *Illinois Public Act 97-0749*
  Signed by Illinois Governor Quinn, July 6, 2012

That simple one-sentence addition to the Illinois Economic Development for a Growing Economic Tax Credit Act (EDGE) brings with it a host of privacy concerns for businesses seeking to secure tax credit agreements under the EDGE. For agreements entered into on and after July 6, 2012, the Department of Commerce and Economic Opportunity (DCEO) is required to post on its website the terms of each EDGE Agreement that they enter into with every taxpayer. Taxpayers will have to exercise extreme caution in negotiating their agreements - balancing the need to provide enough information to the DCEO in order to secure a tax credit, but not provide information that it seeks to keep private.

While EDGE tax credit recipients are already required to file annual reports that disclose some company and project information, P.A. 97-0749 compels the disclosure of all EDGE agreement terms, which may prove troublesome for many taxpayers. Will this disclosure have a chilling effect on taxpayers seeking EDGE agreements? How much agreement detail will the DCEO disclose? Will the DCEO exercise restraint on disclosing terms that may divulge confidential matters? These are questions that have yet to be answered. The uncertainly around public disclosure should compel a sense of extreme care in taxpayers wishing to negotiate agreements with the DCEO.

Some information is already publicly available - The Corporate Accountability for Tax Expenditures Act

The DCEO is required to comply with the Corporate Accountability for Tax Expenditures Act (Corporate Accountability Act), which requires any recipient that receives economic development assistance from a state granting body to report annually on the progress of the development and employment commitments for the project.

The annual report filed under the Corporate Accountability Act as it relates to EDGE agreements contains some basic taxpayer and project information, including: the taxpayer's name and address, the city name for the project location, the year that the EDGE agreement was awarded by the DCEO, and the amount of tax credit claimed for the year of the accountability report. Basic employee information at the project location as of the application date is included in the form of job classification, number of employees within each classification, and average salary for the classification. The number of new jobs or retained jobs committed to in the agreement is available along with the average salary commitment. The last piece of information that is available is the net number of new jobs added as of the end of the tax year for each report filed as it compares to the agreement. The Corporate Accountability report is filed each year regardless if a benefit is claimed for the year for the duration of the agreement.

Agreement terms that now may be subject to disclosure

P.A. 97-0749 provides that EDGE agreement terms are to be posted on the DCEO's website. Seemingly innocuous terms required in such agreements may take on new significance now that they are to be publicly disclosed. 35 ILCS 10/5-50 enumerates the required elements of an EGDE agreement. Certain elements reviewed below may give companies concern about potential unexpected consequences that may arise by their disclosure.

A detailed description of the project

A detailed description includes the location and amount of the investment and jobs created or retained. The location of the project by city name and the committed number of new and retained jobs has been generally available to the public under the Corporate Accountability Act. However, a "detailed description of the project" has not been available to the public in the past. How much information on the location is the DCEO going to add to the public domain? Will the DCEO be sensitive to company confidential information contained in agreements? Companies may be sensitive to divulging too much information about the project if it gives away proprietary information about the planned activity there.

The credit amount allowed for each taxable year

The total tax credit *claimed* each year is already disclosed in a taxpayer's Corporate Accountability report because it is a reflection of a company's recent activities. An *allowed* tax credit may project a different message. EDGE agreements generally provide a total EDGE tax credit amount based upon new or retained jobs information. This amount is an estimate of the potential EDGE benefit because the calculation does not take into account wage growth or a taxpayer that exceeds the committed targets in the agreement. Companies may provide a conservative estimate for purposes of the agreement to ensure qualification, but intend to satisfy a higher number. A smaller number could be misinterpreted by the public as signifying a lesser investment in the community.

The minimum number of years to maintain operations at the project location

While the EDGE agreement itself is a ten year tax credit agreement, the number of years maintained at a project location may be something different. Similar to the above concern over public disclosure of the number of new or retained jobs, the public disclosure of a finite number of years invested in a location may cause concerns in the community that the business is invested for a predetermined length of time.

A detailed description of the number of new employees to be hired, and the occupation and payroll of the full-time jobs to be created or retained as a result of the project

The number of new or retained jobs and the average salary commitment are aspects of an agreement that have been historically required under the Corporate Accountability Act. However, to the extent a "detailed description" is included in an agreement, such description may be subject to public disclosure. A company should be cautious regarding the level of specificity included in its agreement if it would like to maintain privacy around salary expectations and employment at particular levels.

Minimum capital investment and time period for placing property in service

Investment information has not been made public in the past as part of the Corporate Accountability Act. Companies may proudly boast the investment that they are making in communities, so this disclosure may not cause concern for some companies. The time period for placing property in service could provide the public with more information than a company may desire. Missed milestones could be perceived by the public that the company is not fulfilling obligations and perhaps is decreasing its commitment to the community.

A detailed description of the items included in the EDGE credit limitation

Generally, a company cannot earn more in EDGE tax credit than it invests in the project. This may require a company to complete an investment profile as part of its EDGE agreement. For example, general investment classifications and lease terms are part of the investment profile. The disclosure requirement has the potential to make these investment and negotiated contracts available to the public.

Other terms?

The language added by the 2012 law change requires the DCEO to post "the terms of each Agreement," without any limiting language. The above elements of Sec. 5-50 provide only what is required in an EDGE agreement. However, an agreement may contain many other negotiated terms. Companies should exercise extreme care in their negotiations and in the final drafting of the agreement to ensure that no confidential or other sensitive information is included in an agreement because of the risk that such information may be subject to public disclosure.

Contact Info:

Robert Rischmann, Director, Chicago, (312) 298-2979
robert.r.rischmann@us.pwc.com

FEDERAL & STATE DEVELOPMENTS

While not fully inclusive of all developments in federal and state tax credits and incentives, the following provides highlights of some notable items.

Alabama

New markets tax credit enacted

On May 9, 2012, Alabama enacted H.B. 257, which established a tax credit similar to that of the federal new markets tax credit. [Alabama H.B. 257 (5/9/12)]

Alaska

New markets tax credit enacted

On June 12, 2012, Alaska enacted S.B. 66, which established a new program to provide loans for entities seeking to take advantage of the federal new markets tax credit. [Alaska H.B. 66 (6/12/12)]

Illinois

Changes to the Enterprise Zone Program

On August 7, 2012, Illinois enacted S.B. 3616, which made major changes to the state's Enterprise Zone program.

The law extends the Enterprise Zone Program for 25 years, and creates a process for existing communities with zones and new communities to apply for the designation. Under the new procedure, the Department of Commerce and Economic Opportunity (DCEO) will accept and review all applications to determine if they meet three of 10 criteria to be certified as a zone, which includes unemployment rate, infrastructure, plant closure/job loss, education, poverty rates, and high commercial and industrial vacancy.

The Enterprise Zone Board is created. It will approve or deny enterprise zone applications certified and scored by DCEO. The board will consist of five members: the director of DCEO, or his or her designee, who shall serve as chairperson; the director of the Department of Revenue, or his or her designee; and three members appointed by the Governor.

The law requires that any business receiving tax incentives due to its location within an enterprise zone or its designation as a High Impact Business must annually report the total Enterprise Zone or High Impact Business tax benefits received. The report must be broken down by incentive category and enterprise zone, to the Department of Revenue. Failure to report data shall result in ineligibility to receive incentives. [Illinois S.B. 3616 (8/7/12)]

Iowa

New credits for geothermal and solar energy

Effective May 25, 2012, Iowa provides for two new income tax credits for geothermal heat pumps and solar energy systems installed in residential property. [Iowa S.B. 2342 (5/25/12).

New Jersey

New rules provide guidance for the Business Retention Program and the Grow New Jersey Assistance Program

On June 18, 2012, regulation secs. 19:31 -14.2 to -14.11 and 19:31-18.1 to -18.17 were adopted. These new regulations amended application requirements and definitions for the Business Retention Program. They also implement the new Grow New Jersey Assistance Program, which became effective January 5, 2012. [N.J. Regs. Sec. 19:31-14.2 to 14.11 and 19:31-18.1 to -18.7 (6/18/12)]

New York

Enterprise zone credits denied for failure to satisfy new business test

On June 28, 2012, the New York Tax Appeals Tribunal held that taxpayers did not qualify for tax credits because their reorganization lacked a valid business purpose and was done solely to receive the tax credits. [*Dunk & Bright Furniture*, N.Y. Tax Tribunal, Nos. 823026 (6/28/12)] [*see also, Falso,* N.Y. Tax Tribunal, No. 823587 (6/21/12)]

Enterprise zone credits granted, taxpayer satisfies new business test

On July 10, 2012, the New York Tax Appeals Tribunal found that a taxpayer's reorganization had a valid business purpose and was not done solely to receive tax credits. The court found that the taxpayer's primary motivation to reorganize was to improve its financing abilities. [*Ward Lumber*, N.Y. Tax Tribunal, No. 823209 (7/10/12)