

Budget proposal and other changes impact California's Enterprise Zone program

January 11, 2013

In brief

On January 10, 2013, California Governor Jerry Brown released his proposed 2013-2014 Budget Summary. The budget includes proposed savings from "Enterprise Zone Regulatory Reform." [[2013-14 Governor's Budget Summary](#) (1/10/13)]

On January 11, 2013, the California Department of Housing and Community Development (HCD) issued draft regulations to implement the proposed changes. There is a public comment period that ends February 28, 2013. [[Enterprise Zone Reform Webpage](#), California Department of Housing and Community Development]

The California Enterprise Zone (EZ) program can produce substantial tax benefits that can be used to offset California income taxes, potentially providing approximately \$1 million of tax credit for every 25 qualified employees. There are additional benefits measured by sales taxes paid on qualified equipment placed in service in the EZ. Moreover, documented credits can be carried forward indefinitely.

One key proposed "reform" is that voucher applications documenting Hiring Credits would have to be submitted for approval within one year of the date of hire. This is a significant change since currently employees can be vouchered and claimed as long as the statute of limitations is open for income tax purposes (which allows taxpayers to voucher retroactively for extended periods). The proposed regulations also make many other changes to the administration of the program, and provide additional guidance on how employers may document the eligibility of employees for hiring credit purposes.

Other recent California changes impact the EZ program. Proposition 39 establishes single sales factor apportionment for most taxpayers effective for the 2013 tax year. As a result, certain companies within a combined group may not be able to utilize EZ credits if they don't have third-party sales. Also, the California Supreme Court's *Dicon* decision has empowered the FTB to request documentation supporting EZ voucher certificates, so it continues to be very important for companies to collect and retain good supporting documentation. Finally, taxpayers should consider how San Francisco's new Gross Receipts Tax may have an impact on EZ credits.

In detail

The governor's 2013-14 Budget Summary and the HCD proposed regulations propose the following key reforms:

- Limit retroactive vouchering by requiring all voucher applications to be made within one year of the date of hire (for employees hired before the effective date of the draft regulation, voucher applications must be received within one year of the effective date);
- Require third party verification of employee residence within a Targeted Employment Area (TEA);
- Streamline the vouchering process for hiring veterans and recipients of public assistance; and
- Create stricter zone audit procedures and audit failure procedures."

The applicability of the proposed regulations is as follows:

- The new provisions will apply to voucher applications submitted after the effective date of the regulations; and
- Voucher applications submitted prior to the effective date will be approved based upon the rules in effect at the time.

Regarding the TEA category, third party verification will be required for verification of residence (while forms I-9 and W-4 are not listed as applicable, the Form W-4 is nevertheless required to demonstrate date of hire). The draft regulations provide the following list of items sufficient to verify residence:

- Valid driver's license or other local, state or federal identification card issued within the past five years;
- Voter registration confirmation documents;
- Utility bill;
- Valid passport;
- Mortgage statement;
- County property tax statement; and
- Credit card bill or statements.

The proposed regulations also provide many other new provisions and requirements that will require careful consideration. Some of the other modifications (aside from limiting retroactive vouchering and revising acceptable documentation of residence) include:

- Additional requirements for voucher applications;
- New documentation standards for non-TEA categories (e.g. economically disadvantaged, terminated, laid-off, etc.);
- New audit procedures; and
- Miscellaneous technical updates and an increase in the voucher application fee.

Timing of proposed changes

The HCD proposed regulations could be effective within a few months. It is noteworthy that the Governor's Budget Summary includes an estimate that the new regulations will increase general fund revenue by \$10 million for the 2012-13 year, suggesting that the proposed changes are expected to be adopted quickly. The proposed regulations are open for public comment until February 28, 2013.

There will be four public hearings, on February 12, 13, 20, and 28.

EZ credits produce substantial tax benefits

Companies that operate in Enterprise Zones are eligible for substantial tax credits and benefits including:

- Hiring Credits of up to approximately \$38,000 per employee (taken over 5 years); and
- Income tax credits based upon sales/use taxes paid on purchases of up to \$20 million (for corporations, others have a \$1 million limit) of qualified equipment.

Potential traps based upon income tax rules

There are limitations on the utilization of EZ credits that arise because of California income/franchise tax rules, including the following:

- Credit utilization is limited based on the separate tax liability of each corporation determined through intrastate apportionment;
- EZ credit utilization is further limited to the tax liability attributable to a taxpayer's activities in a zone;
- Credit utilization is limited to the company earning the credit absent assignment of the credit to an affiliate;
- Limited opportunities to assign EZ credits to unitary affiliates; and
- Special rules regarding disregarded entities (DREs) that can further restrict the utilization of credits, including limiting the credit related to a DRE to the income tax attributable to the DRE on a stand-alone basis.

The limitations can be especially challenging for companies that do business through multiple separate legal entities. The recent enactment of a mandatory single sales factor for income tax apportionment purposes under Proposition 39 (effective for tax years beginning on or after January 1, 2013 for most businesses) results in companies having California income tax assigned to them only if they have third-party sales. To the extent an affiliated group of companies has a sales entity and another entity with activity that generates the credit with no third-party sales, the credit could become trapped. Making a protective claim to elect an equally weighted three-factor formula based upon the recent decision in *Gillette* and FTB Notice 2012-1 may be one consideration for such companies.

Documentation required on audit
Additionally, the California Supreme Court in *Dicon Fiberoptics* held that the FTB is not required to accept a voucher certificate issued by a zone coordinator as conclusive evidence that an employee is qualified. In light of this ruling, the FTB is aggressively auditing previously conducted EZ studies to ensure that they agree with the supporting *documentation* underlying the voucher.

Moreover, the proposed regulations provide that voucher applications contain the following statement:

"Issuance of an Enterprise Zone Voucher Certificate is not intended to create a rebuttable presumption in favor of the taxpayer for the issuance of a credit. To receive a credit, taxpayers who receive a Voucher must still meet all qualifications of the Revenue and Taxation Code section 17053.74 or 23622.7 and may be audited by the Franchise Tax Board."

Additional changes in the works

The Budget Summary also notes that the Administration will be pursuing further Enterprise Zone reform through legislation. Currently, EZ credits may be carried forward indefinitely, and it is possible that the Administration will seek to limit the carryforward period, or propose other changes that will negatively impact the value of the EZ credits.

San Francisco Payroll and Gross Receipts Taxes

EZ Credits can in certain cases also be used to offset the current San Francisco Payroll Tax and also the new San Francisco Gross Receipts tax. The San Francisco Gross Receipts tax, approved by voters in November

2012, is being phased in over a period of five years beginning in 2014.

The takeaway

For companies that have not taken full advantage of the EZ program, time may be running out. There are a number of reasons companies may have not fully captured their potential EZ benefits in the past. For example, sometimes companies do limited scope projects, documenting employees who work and live in EZs (TEAs), but not increasing the EZ credits by obtaining information about other qualifying criteria that also support that EZ credit. Another example involves companies that are marginally profitable, or that have excess EZ credits, that perform only a limited scope documentation of available credits. In these cases, the companies historically have had the luxury of being able to retroactively voucher additional employees as additional credits are needed. However, given the proposed reforms to limit retroactive vouchering, there may be a limited window in which to document additional credits. Since under current rules EZ credits may be carried forward indefinitely, it may be worthwhile to consider increasing EZ credits now.

Let's talk

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