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OVERSIGHT HEARING

Implementation and Effectiveness of California's New Employment Credit

1021 O Street, Room 1200
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BACKGROUND

This background paper prepares the members of the Senate Governance and Finance Committee for the March 8, 2023, oversight hearing on the New Employment Credit (NEC).

This paper:

- Provides a history of tax credits for Economic Development;
- Details the enactment of AB 93 (Committee on Budget, 2013) and SB 90 (Galgiani, 2013), which enacted the NEC as a replacement for the enterprise zone hiring credit;
- Provides background on how the NEC works;
- Provides history on the NEC of how much is claimed;
- Discusses barriers identified to claiming the NEC; and
- Summarizes the pending proposal from the Governor to modify the NEC.

History of Tax Credits for Economic Development

California's enterprise zone program, the result of collaboration between former Assembly members Pat Nolan and Maxine Waters (AB 40 and 514, 1984, respectively), evolved from a well-intentioned legislative effort to use tax credits to draw investment into economically depressed rural and urban areas into an almost half-billion dollar tax credit program. The Department of Housing and Community Development administered the program, taking over from the Trade and Commerce Agency in 2003. Taxpayers in enterprise zones and other geographically targeted economic development areas (GTEDAs) could claim income and corporation tax credits for hiring qualified individuals and paying sales tax on equipment purchases. It also allowed banks to qualify for a net interest deduction for loans made to a business located within the designated zones.

The most significant incentive was the hiring credit. Employers inside an enterprise zone could claim an Enterprise Zone Hiring Credit (EZHC) equal to 50% of the wages paid to a qualified employee in the first year of employment, 40% in the second year, 30% in the third year, 20% in the fourth year, and 10% in the fifth year, up to 150% of the minimum wage. Businesses or consultants submit applications to qualify employees to zone managers designated by the local agency managing the zone, who grant the firm or consultant a voucher certifying eligibility if the employee qualifies. The firm then claims the credit on its tax return for the wages paid to the employee. Qualified employees include any of the following individuals:

- Eligible for job training programs;
- Eligible for most social welfare programs;
- Economically disadvantaged;
- A "dislocated worker," as defined;
- A disabled individual who is eligible or enrolled in a state rehabilitation plan;
- Service connected veteran;
- Ex-offender; or
- Member of a federally recognized Indian tribe.

In addition to the criteria listed above, employers could also claim the EZHC for residents of Targeted Employment Areas (TEAs). State law allowed cities and counties managing enterprise zones to draw TEAs to contain census tracts where 51% or more of the individuals are low or moderate income, meaning 80% of the area wide, or countywide, median. In other words, local agencies drew TEAs to include communities where only half of the residents were low-income, but anyone who lived in one qualifies his or her employers for the hiring credit regardless of their own economic status or employability. TEAs did not need to be contiguous to, or drawn within the borders of the Enterprise Zone.

Taxpayers could also receive a certification qualifying an employee for an enterprise zone hiring credit at any time. Taxpayers could claim credits for certified employees who worked for them in past years, then submit claims for refunds for previous taxes paid to FTB under California's general four year statute of limitations for amending past returns, a practice known as "retro-vouchering."

Due to the overuse of the credit amid a fiscal crisis, in his 2011-12 Budget, Governor Brown proposed to repeal all GTEDA tax benefits. The proposal—at the time—according to the Department of Finance, would have increased revenue $343 million (2010-11), $583 million (2011-12). The Governor stated that GTEDAs could continue to provide local incentives, but zone taxpayers could no longer receive state tax benefits. The Legislature did not act on the Governor's proposal at that time.

However, in 2013, the Legislature enacted AB 93 (Committee on Budget) and SB 90 (Galgiani), which reformed California's economic development policies by eliminating enterprise zones and other geographically-targeted economic development areas, instead allowing three new tax benefits:

- The New Employment Credit, where the Franchise Tax Board allocates credits for wages paid by taxpayers to qualified employees within former enterprise zones, and other areas that suffer from high levels of poverty and unemployment. The credit was originally enacted for the 2014 taxable year until the 2019 taxable year. The Legislature extended the credit in 2018 until 2026 (SB 855, Committee on Budget and Fiscal Review), which has remained largely unchanged since enacted.

- The California Competes Tax Credit, where the California Competes Tax Credit Committee, also created by AB 93 and SB 90, awards various tax credits up to an annually capped amount to taxpayers who apply as allocated by the committee. SB 855 also extended the authority for the Committee to allocate credits through the 2022-23 fiscal year, and the credit itself through the 2029 taxable year, with some modifications. Last year, the Legislature made further modifications while extending the allocation authority for the credit until 2027-28 (AB 194, Committee on Budget).

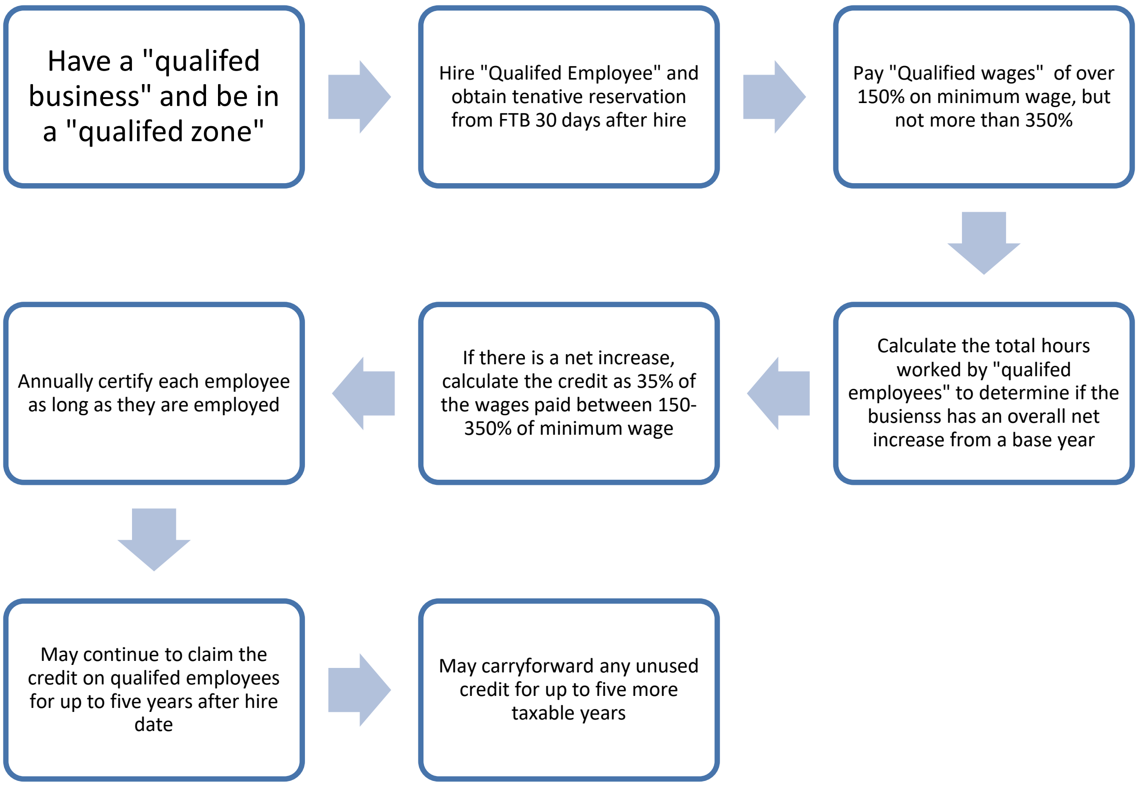
- A state-only (3.9375%) sales and use tax exemption on purchases of manufacturing equipment made by taxpayers within specific North American Industrial Classification System codes, capped at $200 million annually per taxpayer, effective July 1, 2014, and ending July 1, 2022. In 2017, the Legislature expanded and extended this exemption until January 1, 2030, as part of legislation to extend the Global Warming Solutions Act (AB 398, E. Garcia, 2017).

The New Employment Credit

The Legislature enacted the NEC with the overuse of GTEDA tax incentives in mind, resulting in a credit that while similar, contains much more stringent requirements for taxpayers to qualify. Under the NEC, taxpayers can claim credits against the Personal Income or Corporation Tax when they hire a qualified full-time individual on or after January 1, 2014. Qualified full-time employees include the many of the same categories included under the EZHC; previously unemployed persons, veterans, ex-offenders, low-income families with children; but they must also work at least an average of 35 hours per week; and meet other specified requirements. To claim the credit taxpayers must also:

- Receive a tentative credit reservation from the Franchise Tax Board (FTB) for that qualified full-time employee within 30 days from the date of hire; and
- Certify each qualified employee annually with the FTB.

Additionally, state law sets the amount of credit at 35 percent of qualified wages, on wages paid between 150 percent and 350 percent of minimum wage, with the top and bottom wage range increasing over time due to increases in the minimum wage rate. However, taxpayers must also have a net increase in its total number of full-time employees working in California when compared to its base year based on annual full-time equivalents to claim the credit.



Qualified Businesses in Qualified Zones

The Department of Finance (DOF) designates these zones, which are geographic areas where the trade or business must be located that DOF has determined to have the state's highest unemployment and poverty levels. DOF updates these qualified zones every five years

While the EZHC allowed any business to claim the credit, the NEC applied more narrowly by defining a qualified business as one that is not engaged in any excluded businesses, which includes 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 and is not engaged in a sexually-oriented business.

Qualified employees, Wages and Reservations

Qualified employees are full-time employees that must work at least 50% of their time in the zone, be paid at least 150% but not more than 350% of minimum wages, and meet any of the following requirements:

- Unemployed for the previous 6 months or more (unemployed means not receiving wages, not self-employed, and not a full-time student, if the employee completed a college or similar program, the completion date must have been at least 12-months prior to date of hire);
- Veteran, separated from the U.S. Armed Forces within the previous 12 months;
- Received the federal Earned Income Tax Credit in the previous taxable year;
- Ex-offender convicted of a felony;
- Current recipient of CalWORKS or county general assistance.

After the employer hires a quailed employee, they must obtain a tentative credit reservation for that employee by filing with FTB within 30 days from the date of hire.

Net Increase in Employment and Credit Calculation

To calculate whether the business has an overall "net increase" in employment, the business will need to subtract the number of hours worked by all employees (qualified and not) from the number of hours worked in the "base year." If the number is more than zero, then a credit can be calculated. The base year is the year before the company first claims the credit. If the business is new, then their base year is zero.

The amount of the credit is calculated 35% of wages paid between 150% and 350% of minimum wage or the number of full-time equivalent employees. The credit may be claimed for up to five years after the hire date for qualified employees.

History of the Credit

When the Legislature enacted the NEC in AB 93 and SB 90, revenue estimates projected taxpayers would claim $22 million in NECs in the 2014 taxable year, and $69 million in the 2015 taxable year. However, final valid claims were $340,822 in year 2014 (two percent of the initial estimate) and $693,323 in 2015 (one percent of the initial estimate). Over these first two tax years the credit was available, at least 1,829 taxpayers claimed the credit, but FTB determined that 83 percent of the claims were invalid. FTB reports that $3.3 million in NECs were generated for the 2018 tax year, $3 million for the 2019 tax year and $3.9 million in the 2020 tax year.

Over the years since the enactment of the NEC there have been many proposals to modify the credit, including the proposal included in Governor Newsom's 2023-24 budget.

Below is a comparison of the most recent proposals that would change the NEC.

Proposal	Geographic Restrictions	Employer Restrictions	Employee Restrictions	Credit Calculation	Reservation Requirement
New Employment Credit (Existing law)	Required – designated zones	All except: temp help, retail trades, food services, alcoholic beverage places, theatre companies, casinos, and no sexually-oriented businesses	Must be either: Unemployed, a veteran, received federal EITC, convicted felon or current recipient of CalWORKs	35% of the wages between 150%- 350% of minimum wage.	30 days after hire date and annually.
Governor Brown 2018-19 Budget Proposal	No Changes	Allowed restaurants and retailers	No changes	Modified to allow at 100% of minimum wage	Removed annual certification
SB 1349 (Caballero) 2022	Modified to allow all employers to hire within the entire state	No Changes	Same, but added another category to include those currently qualified for federal WOTC[1]	No Change	No Change
Governor Newsom 2023-24 Budget Proposal	Modified to allow certain semiconductor businesses to hire within the entire state	No Changes	No Changes	No Changes	Allows the expanded semiconductor businesses to get a reservation 30 days prior to the end of their taxable year

[1] Work Opportunity Tax Credit

According to data provided from the FTB,[2] the following credits have been claimed over the last three years.

Total Credit Allowed by Tax Year* Tax Year	Number of Returns	Total Credits Allowed
2019	403	$3,582,380
2020	378	$4,239,048
2021*	309	$4,948,469
Total	1,090	$12,769,897

*Not all timely 2021 tax year returns have been processed in this total.

Barriers to Claiming the Credit

The Legislative Analyst's Office states that the low amounts of credits claimed suggest that the existing tax credit has been challenging or unappealing for businesses to use, and cites that the credits' high wage threshold, small credit amount, complexity, uncertainty, and interaction with other credits contribute to low participation.

Another restriction that may be hindering use is that taxpayers must demonstrate an overall increase in employment as compared to a base year, meaning that a company must keep continually increasing their workforce year over year. A new business that is rapidly expanding can easily meet this target, but more established firms are less likely to continuously increase employment.

Additionally, the statute requires that the employer and employees be located areas that are designated to have the highest unemployment and poverty levels, but only allows employers to generate credits when paying workers more than 150% of minimum wage. However, census tracts where businesses pay residents high wages are unlikely to have high unemployment and poverty rates. Further, if employers do find someone to hire in these designated areas, the employer must obtain a reservation from FTB within 30 days from the date of hire. If the reservation is late or isn't filed until the end of the taxable year, employers will be unable to claim the credit on that employee.

In their March 2022 summary report, the FTB notes some barriers to employers claiming the NEC as the following:

> "The tax year totals are well short of initial program estimates. With seven tax years of data available, it is evident that over time, taxpayers are claiming a larger percentage of the generated credit. Despite the increase in credit claims, it still does not appear that the program has sufficient incentives to induce desired taxpayer behavior. The FTB believes the following factors may be curtailing the use of NEC credits:
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> - Complexity: There are multiple standards a qualified employer and a qualified employee must meet in order for the employer to qualify to claim the credit. Complex programs are often associated with more frequent taxpayer return errors.
>
> - Claiming without a reservation: There is some evidence that of those claiming the NEC, predominately for the first few tax years of the program, not all those claiming the credit made reservations and thus were not qualified to take the credit.

[2] https://www.ftb.ca.gov/about-ftb/data-reports-plans/index.html

- Employment challenges during COVID-19 pandemic: In order to generate credits, the employer must have a net increase in the total number of full-time employees employed in California. In 2020, the prevalence of business shut-downs and subsequent difficulty in recruiting new employees likely contributed to the decline in credits generated."

Governor's 2023-24 Budget Proposal

The Governor's 2023-24 budget proposes to modify the NEC to include those businesses that are engaged in the research or manufacturing or research and development of semiconductor chip. This expansion is presumably to help California to compete with other states to receive those manufacturing companies that are created or expanded as a result of the federal CHIPS Act.[3] The proposal allows those employers engaged in semiconductor manufacturing and research and development, as defined in North American Industry Classification System (NAICS) code section 3344 to hire employees to qualify for the NEC anywhere within the state instead of limiting those hires to certain geographic areas. Additionally, these specific employers would enjoy modified reservation requirements to request a reservation for a qualified employee on or before the last day of the month following the close of the taxable year for which they claim the credit, instead of obtaining a reservation through a reservation system no later than 30 days after the date of hire.

Key Questions

- Are credits such as the NEC a cost-effective means to increase employment and economic growth in the state?
- What is the goal of the NEC? Is it to provide incentives to hire individuals with barriers to employment, invest in the state's economically distressed areas, or for firms to pay higher wages?
- Is the current NEC an effective incentive to increase wages and employment in the state?
- Is the current NEC meaningful for employer decision-making when considering hiring an individual with barriers to employment?
- Does the NEC as currently constructed effectively steer economic activity into economically distressed areas in the state?
- Employers do not generate credit unless they pay wages above 150% of the minimum wage, a level set before the Legislature increased the minimum wage (SB 3, Leno, 2016). Is the 150% threshold too high?
- Are the requirements on employers to claim the credit too cumbersome and complex for the NEC to meet its goals?
- Should the NEC be allowed to sunset, modified to suit certain kinds of businesses, or reformed wholesale similar to Governor Brown's proposal or SB 1349?
- Will the Governor's proposal to relax certain NEC requirements for semiconductor manufacturing or semiconductor research and development serve as an effective incentive to induce semiconductor firms to locate or expand in the state? Should this expansion be considered for all industries?

[3] In 2022, President Biden signed into law the CHIPS and Science Act of 2022. This law provides $50 billion in investments through the U.S. Department of Commerce for a suite on investments in semiconductor research, development, and manufacturing.