CALIFORNIA ENTERPRISE ZONE PROGRAM – E^3 – EMPLOYMENT/ ENVIRONMENT AND ECONOMIC DEVELOPMENT

San Jose, JEDE Hearing
October 8, 2009

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California EZ Overview

The California Enterprise Zone (EZ) Program has been in place since the 1980's and has created broad-based stimulus for increased hiring, capital spending, and general business expansion in economically challenged geographic regions.

With record unemployment rates, a prolonged recession and some of the highest income and sales tax rates in the country, the California EZ program is needed more today than ever to offset these and other current issues facing California business owners, employees and communities throughout the state.

The large pool of unemployed has encouraged many EZ communities to develop specialized training and EZ pre-qualification screening, and placement services using the EZ program benefits as an effective outreach to the business community.

The period of EZ designation is 15 years and a new designation via a competitive application process can result in longer EZ designations. These programs are designed for a long period of time to encourage businesses to commit to the significant original capital outlay, employee hiring and training, and facility/equipment funding of their EZ operations.

The purpose of the California EZ program is to "stimulate business and industrial growth in the depressed areas of the state by relaxing regulatory controls that impede private investment" and "help attract, retain and expand business activity, as well as create increased job opportunities" (Section 7071 of the Government Code). In effect, businesses are incentivized to "do the right thing" in the most underserved communities in the state – thereby moving economically challenged residents from the government assistance rolls to the private sector.

The EZ Program benefits include:

- Employer Hiring Credits (up to $13,000 per qualified employee/per year),
- Sales/Use Tax Credits for technology, manufacturing, processing, pollution control, energy conservation and research & development equipment,
- Favorable financing and exclusion of net interest deduction for lenders,
- Employee-level annual tax credits for simply working in an EZ (up to $525/ year),
- Favorable asset expensing and NOL rules and
- Potential local grants, liberalized contract bidding and fast-track permitting, etc.

California EZs encompass portions over 54 Assembly Districts and more than 35 Senate Districts; therefore, approximately 80% of state legislators have EZ qualified companies, employees, residents and communities in their districts.

Despite some commentators' assertions that the majority of EZ credits are utilized by large companies, the reality is that the majority of EZ credits are actually utilized by small businesses and their owners. It should be noted that large corporations are generally structured as C Corps and the EZ credits are retained at the C Corp level and used to offset the C Corp tax liabilities. S Corps, LLC's and Partnerships on the other hand pass the EZ credits out to their owners and the EZ credits are used at the owner level. S Corps also retain 1/3 of the credits at the S Corp level and can utilize the credits to offset the 1.5% "toll tax" payable on S Corp taxable income. The EZ credits cannot be used to offset the $800 minimum tax or the LLC gross receipts tax.

Since California has some of the highest income and sales tax rates in the country, along with high labor and energy costs, the EZ program is critically important to encourage California business owners to establish and grow their businesses in one or more of the current 42 EZs.

Despite our excellent weather and other California benefits, business owners evaluate a number of factors, including taxes, labor pool and labor costs, facility costs, cost of capital and regulatory environment in deciding where to locate. Unfortunately, California is consistently rated near the bottom of national surveys evaluating the "business friendly" rankings of all states. There are 40 other states with varying degrees of EZ programs, plus there are hundreds of federal zones throughout the country – therefore, competition from other states must be fully evaluated by California legislators as they evaluate any changes to the current EZ program. The well documented recruiting of California businesses by other states (and other countries) and the exodus of large numbers of large and small companies over the past several years illustrates the need to improve our state tax structure.

The tight credit markets, which we have seen since September of 2008, continue to jeopardize the survival of small businesses. The EZ program can improve businesses' cash flow, balance sheets and profitability – thereby enhancing their ability to get bank loans and equity infusions. Properly financed businesses are more likely to hire and retain their employees and increase capital investment.

Limitations on the use of the Gross EZ Credits – Large vs. Small Taxpayers

Apportionment

In order to fully understand how the California EZ program benefits large and small companies, it is critically important to understand that large businesses with multiple locations are seldom able to utilize all of their EZ credits since they must apportion their tax liability into: i) each EZ they operate in, and ii) all non-EZ regions they operate in, based on the relative payroll and equipment located in each EZ. Therefore, a large business with only 10% of their California operations in an EZ (or multiple EZ's) will generally only be eligible to offset up to 10% of their California tax liability with EZ credits. Since credits earned in a zone can generally only be used to offset taxes associated with taxable income earned in that specific zone, large companies routinely encounter situations where they have significant "excess" credits in some EZs and a shortfall of credits in other EZs. This statutory limitation is somewhat perplexing since credit can be earned in one zone for hiring employees living in other zones, and the EZ program is a state-sponsored incentive program, rather than city-level program. AB 2589 (Runner) attempted to correct this complex inequity several years ago, but this bill did not pass.

2008/2009 Taxable Income Limit – 50% Credit Limit

Another limitation applicable to larger companies relates to the 2008 and 2009 cap of only allowing taxpayers with more than $500,000 of reported taxable income to offset a maximum of 50% of their 2008 or 2009 California tax liabilities with EZ and other California tax credits.

These apportionment and taxable income limits can dramatically reduce the utilization of both hiring and equipment EZ credits for larger companies.

Annual Sales/ Use Tax Limit

Smaller companies, which generally operate as S Corps, LLCs or Partnerships, are subjected to a strict limitation on sales and use tax credits. Unlike C Corps that can claim credits for sales/use tax paid on up to $20,000,000 of "qualified technology, manufacturing, processing, pollution and energy control equipment, individuals and "pass-through" entities, such as S Corps, LLC's and Partnerships, are only allowed to claim sales/use tax credits on the first $1,000,000 of qualified equipment purchases each year – 95% less than taxpayers operating as C Corps. These equipment credits are only available for assets used exclusively in an EZ. In addition, the asset must generally be acquired from a California manufacturer or distributor –so the sales/use tax credit helps both EZ and non-EZ California-based companies and increases overall state tax collections.

<u>EZ Program Benefits - Large vs. Small Businesses</u>

As outlined above, the legal structure and size of the taxpayer can have a significant impact on the net impact from operating in an EZ.

Based on projected 2008 IRS filing statistics available at www.irs.gov , nearly 360,000 C Corp returns will be filed in California. Businesses that operate as C Corps are typically very large companies as well as numerous smaller businesses that were established years ago before S Corps and LLC's became the legal entities of choice. Not surprisingly, over twice as many (approximately 750,000) LLCs, Partnership and S Corp tax returns were estimated to be filed in California for calendar 2008. These flow-through entities are virtually always small businesses.

The most recently released 2006 statistics for all California geographically targeted economic development areas (G-TEDAs), which include the EZ program, reported the following number of taxpayers claiming credits and the value of credits claimed by businesses and individuals:

	Number of Credits Claimed	***Value of Credits Claimed***
Corporations	4,851	$231 million
Individuals	9,973	$223 million

It is very important to note that these figures reflect the amount of tax credits claimed for the 2006 year and would include carryovers from prior years for many taxpayers. Based on my experience as a CPA, with a large number of clients operating in EZs, larger businesses are likely to only use a fraction of the EZ credits as tax offsets due to the aforementioned apportionment limitations; therefore, it is difficult to determine the precise amount of credits generated in the current year and the amount of credits from prior years which offset 2006 tax liabilities..

Unfortunately many businesses do not complete all lines of the FTB Form 3805Z (Enterprise Zone Credits and Benefits) and the FTB and HCD are not able to gather all information related to gross receipts, total employees and EZ eligible employees associated with EZ operations. Since larger companies are more likely to complete Form 3805Z as compared to smaller companies, since they have more tax reporting sophistication, erroneous conclusions have been reached that the majority of business claiming EZ credits are those making more than $1 billion.

As reflected above, almost twice as many individual taxpayers claim credits (via "flow-thru" of credits from S Corps, LLCs, Partnerships and Schedule C filers) than C Corps do and the amount of credits claimed by individuals is almost equal to those claimed by C Corps. As previously mentioned, smaller businesses typically have less business locations and therefore have less apportionment limitations on utilizing EZ credits as compared to large companies with many locations. Therefore, smaller companies typically obtain more relative value in the form of labor and equipment cost reductions under the California EZ program as compared to larger companies.

Based on the federal filing statistics and the following credit amounts reported by California taxpayers, it is clear that the vast majority of EZ credits are being claimed by smaller businesses.

Since California has the highest marginal income tax rates, as well as the highest sales tax rates in the country, the EZ program is critically important to retain the state business tax base. In addition to being surrounded by states with lower tax rates, lower labor costs, lower energy costs and less regulation, 40 other states have their own versions of tax incentive programs which can be attractive to California business owners. Therefore, retention of the California EZ program is critical for existing California businesses, California workers, as well as businesses considering a move to, or formation in, California.

While both large and small businesses are important to employment, capital expenditures and the local, regional and statewide economies, small businesses are arguably the main driver in generating jobs – particularly as we begin to climb out of this prolonged recession. Smaller, entrepreneurial companies are more inclined to locate in urban areas where rents are often more reasonable and local, experienced labor is readily available. The EZ program encourages employers to hire local residents as well as economically challenged residents in surrounding cities; therefore, small businesses are generally well positioned to utilize the various aspects of the EZ program – particularly the hiring credit benefits.

EZ Program and Its Impact on Manufacturing, Distribution and Environmental Investment

The importance of the California EZ Program and its impact on manufacturers, processors and environmental related companies can be very significant.

Typically manufacturers and processors hire a high percentage of employees from the surrounding community. In addition, these sectors of the economy tend to employ workers that fall into other qualifying criteria such as recent lay-offs from larger companies, military veterans, economically challenged youth and others receiving government assistance, etc. By hiring these EZ targeted workers, the business owners are able to lower their after-tax labor costs, and are encouraged to hire from the local community.

So in addition to employing and training those workers targeted under the EZ program, these employers often add additional value to their inner-city communities they operate in by reducing unemployment and attracting local skilled labor who might otherwise be required to travel to other cities for work – thereby reducing freeway congestion and pollution.

Manufacturers remaining in the state are often required to invest heavily in modernizing equipment and upgrading pollution and energy control equipment. The EZ sales and use tax credits offer the perfect incentive for these often cash strapped companies.

Despite the economic challenges in California, virtually all businesses are continuing to increase investments in technology and pollution/energy control equipment. Environmental companies ranging from bio-fuels developers, to electric vehicle manufacturers, research & development incubators, to emission controls companies, find the EZ program an attractive way to remain competitive with out-of-state competitors. Many of these companies are small, entrepreneurial start-ups. Since the EZ sales and use tax credit provisions generally mandate purchasing equipment from California vendors, EZ businesses will stimulate business for equipment vendors regardless of whether the vendor is in an EZ.

By utilizing the EZ program to attract and retain businesses investing in green technologies, California is very well positioned to capitalize on these evolving eco- industries.

Suggested Refinements to the California EZ Program

1) Increase the sales/use tax limit on the first $1 million of "qualified" equipment for flow-thru entities (S Corps, LLCs and Partnerships) up to the $20 million limit allowed for C Corporations.

2) Allow credits generated in any of the 42 EZs to offset taxes attributable to any other EZ – similar to AB 2589 (Runner). Ref. 3.11

3) Allow the 6% state portion of the sales tax amount to be used as an immediate exemption against the sales tax payable on assets used exclusively in an EZ. Similar to the "exemption in lieu of credit" election available under the expired Manufacturer's Investment Credit.

4) For assets used at least 50% of the time in one or more EZ, allow the sales/use tax to be claimed on a pro-rata basis. For example, if construction equipment, LNG trucks, or portable technology equipment is operated in one or more EZs 70% of the time during the year of acquisition, then 70% of the sales/use tax credit may be claimed. If the equipment is used less than 50% of time in an EZ, then no credit can be claimed.

5) Increase the employee hiring credit from $525 to $1,000 and increase the employee AGI thresholds so that employees will actually derive benefit. Also require employer notification of eligible employees at time of issuing W-2s. Ref. 3.20

6) Modify the Net Interest Deduction (NID) language to allow the exclusion in any case where the lender can prove that at least 75% of loan proceeds were used exclusively for EZ business operations for the tax year. Also statutorily confirm that any real estate loans for an EZ facility (whether for original acquisition or improvements) will be treated as eligible for NID exclusion. Ref. 3.19

7) Create a tax credit for real property and building purchases. Ref.3.21

8) Consideration should be given to expanding the number of Enterprise Zones in light of the increased unemployment rates and poverty levels throughout the state.

****All References ("Ref.") above are to Appendix F of the "California Enterprise Zone: A Review and Analysis" report prepared by the Assembly Jobs, Economic Development, and the Economy Committee***.

Examples of Small Businesses Benefiting From the California EZ Program

1) Manufacturer – Second generation store display manufacturer used credits to retain U.S. jobs and acquire new manufacturing and CAD design equipment to remain competitive

2) Start-up Bio-Fuels Company – processing plants planned for two EZ locations

3) Food Processor – Third generation fish processor added production lines and new products with tax savings from credits

4) Gas Station Operator – second generation company used credits to pay for a portion of the mandated pump vapor recovery system and the purchase of additional locations

5) Logistics Company – Conversion of Fleet to Clean LNG trucks. EZ credits used to defray a portion of costs and bridge cash flow constraints.

6) Out of state electric vehicle recharging station distributor – evaluating California EZ locations to build and operate the stations.