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Recession Relief: California's Enterprise Zone Program Offers Tax Benefits for Qualifying Taxpayers

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Overview

With a struggling economy and a massive budget deficit, California could use a jump-start. The California Enterprise Zone Program ("EZ Program") may not be a panacea for the State's problems but can provide real monetary benefits to qualifying taxpayers eligible for state and local tax benefits. Created in 1984, the EZ Program (California Government Code Section 7070, et seq.) was established to "stimulate business and industrial growth in the depressed areas of the State." Administered by the California Housing & Community Development Department ("HCD"), the EZ Program currently authorizes forty-two (42) enterprise zones, each with designations of 15 years and potential expansion rights up to 15% in geographic size.

Qualifying taxpayers include businesses of all sizes and industries located in any of the State's designated enterprise zones. In recent years, the EZ Program has expanded its reach by adding new enterprise zones and expanding existing enterprise zones covering substantial portions of most major cities in California. Despite such growth, the most recent statistics show that only 10% of qualified taxpayers are taking advantage of the EZ Program.

Given the current economic hardship faced by many California businesses, qualifying taxpayers should strongly explore whether they might benefit from the EZ Program to reduce or offset their California tax liability.

Tax Benefits Under the EZ Program

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The EZ Program offers state and local tax benefits to qualifying taxpayers located in designated enterprise zones, including, without limitation, tax credits, which can be claimed retroactively for prior years. A tax credit, unlike a tax deduction, is a dollar for dollar offset against income or franchise tax. In addition to tax credits, the EZ Program offers several other tax benefits. The principal tax benefits are briefly summarized below.

- *Hiring Tax Credits* - Credits for hiring certain individuals over a five-year period. Qualified hires must fall within one of 14 categories such as residents of a targeted employment area, dislocated workers, veterans, government benefits recipients, etc. The credits generally are calculated on an hourly basis and applied as follows: (i) 50% for the first year of wages, (ii) 40% of second year wages, (iii) 30% of third year wages, (iv) 20% of fourth year wages, and (v) 10% of fifth year wages. The maximum credit per qualified hire may be claimed over a five-year period. Generally, such credits are subject to a 50% cap on offsetting tax liability for 2008-2009.

- *Sales or Use Tax Credits* - Credits for sales/use tax paid on the first $1 million in qualified machinery and parts, data processing and communications equipment and motion picture manufacturing equipment central to production and post-production (for individuals and businesses taxed under the personal income tax law) or the first $20 million (for corporations) used in manufacturing, processing and related activities within an enterprise zone. Generally, such credits are subject to a 50% cap on offsetting tax liability for 2008-2009.

- *Business Expense Deductions* - Up to 40% of property costs (personal property, equipment, and furnishings) can qualify as an up-front business expense deduction, rather than as a capital expense subject to depreciation.

- *Net Interest Deductions* - A net interest deduction for lenders, based upon the net interest received from loans made to qualifying taxpayers located in enterprise zones.

- *Net Operating Losses* - Up to 100% of losses can be carried over for 15 years, except for 2008-2009, whereby such NOLs are temporarily suspended. No carryback is currently permitted but may be permissible commencing in 2010.

EZ Program Legislation

Recent legislation has modified the EZ Program for tax years 2008-2009. AB 1452 and SBX1 28 were signed in 2008 by Governor Schwarzenegger to limit the tax benefits available for such tax years, including an NOL suspension until 2010 and a 50% cap on offsetting tax liability with respect to claimed tax credits. Note that taxpayers with less than $500,000 in "net business income" are exempt from both the NOL suspension and the 50% credit usage limitation. Further, any credits that go unused because of the limitation in such tax years will carry forward.

Future legislation concerning the phase-out, cancellation or other modification of the EZ Program cannot be predicted with any degree of certainty. The California State Legislature is currently weighing recommendations to phase out the EZ Program in order to help solve the State's massive budget shortfall. It is unclear whether such efforts will succeed legislatively to reduce or eliminate tax benefits under the EZ Program, and as of this writing, there are no formal proposals to limit or eliminate any active enterprise zones. That said, if EZ Program tax benefits are eliminated or scaled back, it is anticipated that legislative changes would be prospective. Accordingly, qualified taxpayers considering engaging in business activities in a designated enterprise zone, or which have already engaged in such activities eligible for tax benefits, should strongly consider taking the necessary actions to qualify for or claim such benefits before they are potentially lost.

Conclusion

The EZ Program offers significant tax benefits for qualifying taxpayers but faces future uncertainty. EZ Program tax benefits appear to be in the legislative crosshairs. Whether this will translate into actual legislative change remains to be seen. Accordingly, the potential threat of diminished tax benefits under the EZ Program should encourage taxpayers to capitalize on such opportunities before they are potentially lost.

For more information concerning the EZ Program, California taxpayers are encouraged to contact their individual tax advisors. The author can be reached at (310) 312-4256 or mportnoff@manatt.com. In addition, taxpayers can visit: www.hcd.ca.gov/fa/cdbg/ezOver (State of California, Housing and Community Development Financial Assistance Division).

back to top

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Matthew A. Portnoff Mr. Portnoff's practice covers a broad range of federal and state income tax matters, with a particular emphasis on corporate acquisitions, partnerships, real estate taxation, tax-exempt financing, nonprofit taxation, and general business tax planning. Mr. Portnoff also has experience in the formation of corporations, partnerships and limited liability companies, and provides related tax planning advice.