taxanalysts viewpoint

Not So EZ Anymore? The Tenuous State Of California's Enterprise Zone Credit

by Andres Vallejo and Scott M. Reiber

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California's Enterprise Zone Act was promulgated "to stimulate business and industrial growth in the depressed areas of the state by relaxing regulatory controls that impede private investment" and to create a "strong, combined, and business-friendly incentive program to help attract business and industry to the state, to help retain and expand existing state business and industry, and to create increased job opportunities for all Californians."[1] Two of the incentives provided to businesses operating within enterprise zones are the enterprise zone (EZ) hiring credits and EZ sales and use tax credits.[2] In broad terms, those EZ credits provide taxpayers with credit against their franchise tax liability as a result of some sales taxes and wages paid in EZs.[3]

For a number of years the California Franchise Tax Board has sought, through litigating positions and administrative pronouncements, to limit the ability of taxpayers to take advantage of the EZ tax credits. That gradual chipping away at the availability of those credits appears to have come to a head this year with administrative proposals to dramatically alter the EZ credit program and legislative proposals to eliminate portions of the program or modify it entirely. Because the continuing viability of California's EZ credit program is unclear, taxpayers should take advantage of the credits while they can, continue to monitor legislative and administrative developments on the program, and adjust accordingly.

Litigation Limiting the Availability of EZ Credits

There have been several cases in recent years in which the FTB has attempted to limit the extent to which taxpayers may take advantage of California's EZ credits. Although the FTB has not always successfully defended its position, in each case the FTB has used the litigation to limit taxpayers' use of EZ credits.

Taxpayers' Pyrrhic Victory In *Appeal of NASSCO*

In *Appeal of NASSCO Holdings, Inc.*, the taxpayer argued that it was entitled to apply its EZ hiring credits to reduce its alternative minimum tax liabilities.[4] EZ hiring credits permit taxpayers to take a credit against their franchise tax liability equal to a percentage of the wages paid to "qualified employees."[5] The parties in *Appeal of NASSCO* agreed that the employees generating the credits were "qualified employees," and that the taxpayer otherwise satisfied the statutory requirements for generating the EZ hiring credits.[6] However, the parties disagreed over which "tax" may be offset by the EZ hiring credits.

The taxpayer cited clear legislative history that the State Legislature intended to permit taxpayers to use the credits to offset both regular franchise tax

[1]Cal. Gov't Code section 7071(a) and (b).

[2]Calif. Revenue and Taxation Code sections 23612.2 and 23622.7.

[3]*Id.*

[4]*Appeal of NASSCO Holdings, Inc.*, SBE Case No. 317434, 2010 Cal. Tax LEXIS 416 (Nov. 17, 2010).

[5]Calif. Revenue and Taxation Code section 23622.7.

[6]*Appeal of NASSCO*, 2010 Cal. Tax LEXIS 416 at *2.

and the AMT.[7] The FTB, however, interpreted the statutes in a manner that would treat taxpayers with identical tax liabilities differently depending on whether their liability consisted of regular tax or the AMT.[8] Finding that the FTB's interpretation would "produce[] absurd results," the State Board of Equalization ruled in favor of the taxpayer.[9]

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In FTB Notice No. 2011-02 (Mar. 18, 2011), however, the FTB attempts to make lemonade out of its *Appeal of NASSCO* lemons. It takes the position that a taxpayer that was liable for the AMT for tax years since the current EZ credits were available (that is, since 1994), must *reduce* any available EZ credit carryovers to the extent that the taxpayer could have used its EZ credits in prior years to offset its AMT had the statute of limitations not been closed. In other words, the FTB is penalizing taxpayers for following its explicit position in prior years. Thus, rather than *Appeal of NASSCO* resulting in significant refunds for taxpayers, the FTB is attempting to obtain a windfall as a result of its erroneous interpretation of the statute. Whether the FTB's position would survive judicial scrutiny is questionable, and taxpayers adversely affected by FTB Notice 2011-02 may want to consider challenging the FTB's position.

EZ Sales and Use Tax Credits Limited In *Taiheiyo Cement*

In *Taiheiyo Cement U.S.A., Inc. v. Franchise Tax Board*, the taxpayer argued that it generated EZ sales and use tax credits when it paid sales and use taxes on currently expensed assets.[10] EZ sales and use tax credits generally permit taxpayers to take a credit against their franchise tax liability for sales and use taxes paid in connection with the taxpayer's purchase of "qualified property."[11] At issue in *Taiheiyo Cement* was whether that "qualified property" was limited to capital assets (that is, assets with a useful life of greater than one year), or whether it also encompassed currently expensed assets (that is, assets consumed within one year).

The taxpayer claimed that the FTB's unstated policy of permitting the credits only for capital assets was an impermissible "underground regulation" because the statute made no reference to a capitalization requirement.[12] However, the Court of Appeal, construing the statutory language strictly against the taxpayer, concluded that the credit applied only to capital assets because the definition of qualified property in the statute used the terms "placed in service" and "basis," which are terms commonly associated with capital assets.[13] The appeal court inferred from the use of those terms that the State Legislature had intended the credits to apply only to capital assets.[14]

Taxpayers Left in Limbo Following *Dicon*

The case that is likely to have the most significant effect on California's EZ credit program is the California Supreme Court's decision in *Dicon Fiberoptics, Inc. v. Franchise Tax Board*.[15] *Dicon* involved California's EZ hiring credits (described above), and whether the taxpayer's employees were qualified employees that were eligible for the credits. In broad terms, a qualified employee must fall into one of several statutory categories, including, for example, an "economically disadvantaged individual 14 years of age or older," an ex-offender, or an individual who resides in a "targeted employment area."[16]

Before taking the EZ hiring credit on their return, taxpayers must obtain a certification (or voucher) from a local agency certifying that the employee is a qualified employee.[17] To obtain that voucher, the taxpayer submits information to the local agency showing that the employee meets at least one of the statutory categories of qualified employees.[18] The agency then issues the voucher to the employer. During the years at issue in *Dicon*, the instructions printed on the voucher stated that the first page of the voucher "should be separated at the perforation and provided to the employee, the employer or an agent of that employer. *The eligibility sections contain confidential information to be retained by the vouchering agency, and should not be provided to the employer.*[19] In other words, the vouchering agency retained the confidential information proving that the employee was a qualified employee, and the employer was given the voucher itself.

Even though the taxpayer in *Dicon* obtained the vouchers from a local agency certifying that its employees were qualified employees and provided those vouchers to the FTB, the FTB audited the

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[7]*Id.* at *15-*16.
[8]*Id.* at *12-*13.
[9]*Id.* at *12.
[10]*Taiheiyo Cement U.S.A., Inc. v. Franchise Tax Board*, 204 Cal. App. 4th 254 (2012).
[11]Calif. Revenue and Taxation Code section 23612.2.
[12]*Taiheiyo Cement*, 204 Cal. App. 4th at 257.
[13]*Id.*
[14]*Id.* at 263.
[15]*Dicon Fiberoptics, Inc. v. Franchise Tax Board*, 53 Cal. 4th 1227 (2012).
[16]Calif. Revenue and Taxation Code section 23622.7(b)(4)(A)(iv).
[17]Calif. Revenue and Taxation Code section 23622.7(c).
[18]Form TCA EZ1 (revised June 1998).
[19]*Id.* (emphasis in original).

taxpayer and refused to accept the vouchers.[20] The FTB demanded that the taxpayer provide additional documentation establishing that the employees were qualified employees.[21] The Court of Appeal, in a well-reasoned opinion, held that the vouchers constituted prima facie evidence that the employees were qualified employees, and that while the FTB could audit the vouchers, the burden was on the FTB to prove that the employees were *not* qualified employees.[22]

The California Supreme Court reversed the decision of the Court of Appeal, and held that the vouchers constituted nothing more than an additional requirement that taxpayers must meet to obtain the EZ hiring credits.[23] The court concluded that the FTB had the authority to audit the vouchers, and the burden remained with the taxpayer to prove that the employees satisfied the statutory requirements to be qualified employees.[24] In reaching that decision, the court relied on the FTB's general audit authority and a provision in California law precluding the FTB from being bound by the determinations of another agency (in this case, the agency issuing the voucher).[25]

Thus, following *Dicon*, taxpayers are left with no certainty that they will be entitled to the credits for which they have received certifications from local agencies that their employees meet the statutory criteria. Moreover, because the statutes provide little guidance regarding the documentation required to prove that an employee is a qualified employee, taxpayers are left to guess what documentation the FTB will require at audit to prove that the employees meet the statutory criteria.[26] Thus, taxpayers should retain all potentially relevant documentation for employees for whom the taxpayers claimed the EZ hiring credits, and should not dispose of that documentation until the statute of limitations has closed on the year in which the taxpayer was able to use the EZ hiring credits (either in the first instance or as a carryover item).

Administrative and Legislative Proposals to Modify or Repeal the EZ Credit Program

Following the decisions described above, California has issued proposed regulations and legislation that would dramatically alter, or even repeal, the EZ credit program. Although none of those proposals have been enacted yet, it appears likely that California's EZ credit program will undergo some profound changes soon.

Proposed Regulations Designed to Make 'As Much Reform as Permitted'

Early this year, the California Department of Housing and Community Development issued proposed EZ credit regulations that, according to the initial statement of reasons, seek to make "as much reform as permitted by the current makeup of the statutes governing the Enterprise Zone Program."[27] Importantly, the proposed regulations limit the period within which employers may submit applications for EZ credit vouchers to one year of the date of hire (or one year of the effective date of the regulations, if hired before the effective date of the regulations), impose more exacting requirements on taxpayers regarding the documentation required to prove some categories of qualified employees, and require more accountability on the part of vouchering agencies.[28]

> ***Perhaps the most dramatic change imposed by the proposed regulations are the documentation requirements the proposed regulations place on taxpayers to prove that employees are qualified employees under the statute.***

Perhaps the most dramatic change imposed by the proposed regulations are the documentation requirements the proposed regulations place on taxpayers to prove that employees are qualified employees under the statute. For example, one statutory category of qualified employees is "economically disadvantaged individual[s] 14 years of age or older."[29] Under the proposed regulations, employers would have to show that the employees were enrolled in one of the listed public assistance programs (for example, CalFresh, Medicaid/Medi-Cal, and so on) to prove that they were economically disadvantaged, rather than relying on other potential information (such as the individual's or the individual's family's income level).[30] As another example, to prove that an individual is a

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[20]*Dicon*, 53 Cal. 4th at 1230-1231.
[21]*Id.*
[22]*Id.* at 1231.
[23]*Id.* at 1236.
[24]*Id.*
[25]*Id.* at 1234-1235 (citing Calif. Revenue and Taxation Code sections 19032, 19133, 19504, and 19801).
[26]Indeed, the California Supreme Court in *Dicon* noted that "at the time the vouchers were issued in this case there were *no* statutory or regulatory requirements regarding the documentation required to obtain or issue a voucher." *Id.* at 1237 (internal quotations omitted) (emphasis in original).
[27]Initial Statement of Reasons: Enterprise Zone Program Regulations (Jan. 2013), p.1.
[28]Proposed Cal. Code Regs. tit. 25, sections 8430 *et seq.*
[29]Calif. Revenue and Taxation Code section 23622.7(b)(4)(A)(iv)(III).
[30]Proposed Cal. Code Regs. tit. 25, section 8466(b)(3)(B).

resident of a targeted employment area (another category of qualified employee under the statute), employers may no longer rely on a Form I-9, Form W-4, a statement from the employee's landlord, or the employee's lease or rental agreement, and would instead need to obtain third-party verification of residence (that is, a driver's license, voter registration confirmation, utility bill, passport, mortgage statement, property tax statement, or credit card bills or statements).[31]

There are questions, however, regarding whether the proposed regulations would be valid if passed. Because the proposed regulations appear to alter the scope of the underlying EZ credit statutory scheme, and because the proposed regulations do not appear reasonably necessary to effectuate the purposes of the EZ credit statutes, the proposed regulations may violate the Administrative Procedure Act.[32] Moreover, because the proposed regulations would almost certainly reduce the amount of credits available to taxpayers, the regulations may constitute tax increases that must be passed by a supermajority of the State Legislature under the California Constitution.[33] For those reasons, among others, it is unclear whether the proposed regulations will be passed in their current form, or whether they will be revised significantly before promulgation.

Legislation Modifying or Repealing The EZ Credit Program

In addition to the proposed regulations for the EZ credit program, there are a number of pending bills in the State Legislature regarding the EZ credit program. One active bill, SB 434, would, among other revisions to the EZ credit program, repeal the EZ hiring credit by December 1, 2019.[34] Also, in the Governor's Budget May Revision, Gov. Jerry Brown (D) outlines his plan to "modernize" California's EZ credit program to "meet the needs of the current economy."[35] Although the governor's summary provides few details of his "revenue neutral" proposal, it notes that "the hiring credit will be refocused to specific areas with high unemployment and poverty rates," that the EZ sales and use tax credit will be replaced by an "upfront sales tax exemption for manufacturing or biotech research and development equipment purchases," and that a new fund will be created to "provide businesses tax credits in exchange for investments and employment expansion in California."[36] In a press conference on the governor's May revision, the governor and his staff lamented that the current EZ credits reward taxpayers for moving jobs from one part of California to another, and said that the governor's proposal would focus more on encouraging investment in California.

Conclusion

For the reasons described above, California's EZ credit program — which the FTB has sought to limit in recent years — appears vulnerable to significant, and possibly fundamental, changes. For that reason, taxpayers are best advised to take advantage of California EZ credits while they are available. Taxpayers should also continue to monitor developments in this area, because they could have a significant effect on the availability of the EZ credits in future years. ☆

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[31]Proposed Cal. Code Regs. tit. 25, section 8466(b)(18).
[32]Cal. Gov't Code section 11342.2.
[33]Cal. Const. Art. XIIIA, section 3.
[34]SB 434, as amended May 24, 2013.
[35]Governor's Budget May Revision, 2013-2014, p. 68.
[36]*Id.*