Client Alert

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Deadline Approaching for California's New Employment Credit

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Beginning January 1, 2014, California has replaced the Enterprise Zone Hiring Credit with the New Employment Credit and the California Competes Credit[1], each of which may be used to offset the Personal Income Tax and Corporation Tax.

For taxable years beginning on or after January 1, 2014, and before January 1, 2021, the New Employment Credit ("NEC")[2] is allowed for qualified taxpayers who:

1. hire qualified full-time employees,
2. pay qualified wages attributable to work performed by qualified employees in designated census tract or economic development areas, and
3. receive a tentative credit reservation from the Franchise Tax Board ("FTB") for each qualified full-time employee.[3]

A qualified taxpayer must request a tentative credit reservation from the FTB **within 30 days** of reporting the hiring of a new employee to the Employment Development Department ("EDD").[4] Employers must report the hiring of new employees to the EDD **within 20 days** from the first day of work.[5] Employers that hire new employees are advised to consider whether they qualify for the NEC, and request a tentative credit reservation from the FTB within this short timeframe to maintain NEC eligibility.

1 Please see our Client Alerts of December 4, 2013, and February 11, 2014, for details of the California Competes Credit and proposed regulations pertaining thereto.

2 The NEC is codified at sections 17053.73 (Personal Income Tax) and 23626 (Corporation Tax) of the California Revenue and Taxation Code. All statutory references are to the California Revenue and Taxation Code unless otherwise stated. The Franchise Tax Board has posted an NEC webpage to its website.

3 Sections 17053.73(a)(1) and 23626(a)(1). Click here to access the tentative credit reservation system.

4 Sections 17053.73(e)(1) and 23626(e)(1). Receipt of a tentative credit reservation from the FTB is not a determination of NEC eligibility. Sections 17053.73(e)(4) and 23626(e)(4).

5 California Unemployment Insurance Code section 1088.5.

NEC Amount

The NEC is equal to 35 percent of qualified wages paid or incurred by a qualified taxpayer during the taxable year ("tentative credit amount"). However, no NEC is allowed unless the qualified taxpayer has increased the number of full-time California employees (whether or not qualified employees) from the prior taxable year.[6] To the extent the number of qualified employees exceeds the increase in the number of full-time California employees from the prior taxable year, the NEC will be limited.[7]

For example, if a qualified taxpayer employed 100 qualified employees, but had no increase in total full-time California employees from the prior taxable year, the total allowable NEC would be equal to zero percent (0/100) of the tentative credit amount – and thus no allowable NEC. Alternatively, if that qualified taxpayer had a ten-employee increase in California full-time employees and employed 100 qualified employees, the total allowable NEC would be equal to ten percent (10/100) of the tentative credit amount.[8]

The amount of allowable NEC that exceeds a taxpayer's net tax may be carried forward for a maximum of five years,[9] and must be claimed on a timely filed original tax return.[10]

Qualified Taxpayer

A "qualified taxpayer" is a corporation or other business entity engaged in a trade or business within a designated census tract or economic development area[11] that pays qualified wages during the taxable year.[12] A "qualified taxpayer" shall not include any of the following (collectively, "excluded businesses"):[13]

- employers that provide temporary help services, as described in Code 561320 of the NAICS,[14]
- employers that provide retail trade services, as described in Sector 44-45 of the NAICS,
- employers that are primarily engaged in providing food services, as described in Code 711110, 722511, and 722513 through 722515 of the NAICS,
- employers that are primarily engaged in services as described in Code 713210, 721120, or 722410 of the NAICS (gambling or serving of alcoholic beverages), and

6 Sections 17053.73(b)(1)-(4) and 23626(b)(1)-(4).

7 Sections 17053.73(a)(2) and (b)(1)-(4), and 23626(a)(2) and (b)(1)-(4). For taxpayers who first commence doing business in California during the taxable year, the number of full-time California employees for the previous year for these purposes is zero. Sections 17053.73(c)(2) and 23626(c)(2). A taxpayer does not commence a new business in California where it acquires an existing California business which represents more than 20 percent of the fair market value of the total assets of the business being conducted by the taxpayer. Sections 17053.73(d)(2) and 23626(d)(2).

8 The NEC may not exceed 100 percent of the tentative credit amount. Sections 17053.73(b)(2) and 23626(b)(2). For several examples of how to calculate the NEC, see FTB Frequently Asked Questions ("FTB FAQ") under "Calculating the Credit."

9 Sections 17053.73(k) and 23626(j).

10 Sections 17053.73(a)(4) and 23626(a)(4).

11 Use this link to determine if a location is within a designated census tract or economic development area.

12 Sections 17053.73(b)(11)(A) and 23626(b)(11)(A). The "qualified taxpayer" determination is made at the entity level for business entities taxed as partnerships or S-corporations. See Sections 17053.73(b)(11)(B) and 23626(b)(11)(B).

13 Sections 17053.73(b)(11)(C) and 23626(b)(11)(C). Employers other than "sexually oriented businesses" with gross receipts of less than $2 million during the previous tax year may qualify for the NEC even if engaged in an excluded business. Sections 17053.73(b)(11)(D) and 23626(b)(11)(D).

14 "NAICS" is the 2012 edition of the North American Industry Classification System published by the United States Office of Management and Budget.

- employers that are sexually oriented businesses.

The FTB instructs that a taxpayer engaged in multiple lines of business must select a NAICS code classification that represents its primary line of business to determine if it is an excluded business.[15] The FTB also instructs that if a corporation is part of a combined reporting group, the proper NAICS classification for purposes of determining if it is an excluded business is made on a separate company basis.[16]

Qualified Wages

"Qualified wages" means those wages paid or incurred by qualified taxpayers to qualified full-time employees during the taxable year that (1) exceed 150 percent of the state minimum wage, but do not exceed 350 percent of that minimum wage, and (2) are paid or incurred within the first 60 months of employment.[17]

Qualified Full-Time Employee

A "qualified full-time employee"[18] is an individual who:

- performs at least 50 percent of his or her services for a qualified taxpayer during the taxable year in a designated census tract[19] or economic development area,[20]
- receives starting wages that are at least 150 percent of the minimum wage,
- is hired by a qualified taxpayer on or after January 1, 2014,
- is hired after the date the location of employment is determined to be within a designated census tract or economic development area,
- is either employed an average of 35 hours per week, or is a salaried employee paid on a full-time basis, and
- upon commencement of employment was either:
    1. unemployed for the previous 6 months,[21]

15 FTB FAQ 6, under the heading *Small and excluded businesses*. FTB has not provided guidance as to how such a taxpayer would determine its "primary line of business."

16 FTB FAQ 4, under the heading *Small and excluded businesses*.

17 Sections 17053.73(b)(12) and 23626(b)(12). Minimum wage is the wage rate established by California Labor Code section 1171, et. seq. Sections 17053.73(b)(9) and 23626(b)(9).

18 Sections 17053.73(b)(10)(A)(i)-(vi) and 23626(b)(10)(A)(i)-(vi).

19 A "designated census tract" is a California census tract with a civilian unemployment rate and poverty rate that is within the top 25 percent of all census tracts in California, as determined by the Department of Finance ("DOF"). Sections 17053.73(b)(7), 23626(b)(7), 17053.73(g)(1), and 23626(g)(1).

20 An "economic development area" is either (1) a former enterprise zone, excluding any census tracts with unemployment rates and poverty rates in the lowest quartile of all census tracts in California, or (2) a local agency military base recovery area. Sections 17053.73(b)(8)(A) and (B), and 23626(b)(8)(A) and (B).

2. a veteran separated from service within the previous 12 months,
3. a recipient of the federal Earned Income Tax Credit allowed by IRC section 32 during the previous tax year,
4. an ex-offender previously convicted of a felony, or
5. a recipient of CALWORKS or other general assistance.

All employees of related trades or businesses shall be treated as employed by a single taxpayer.[22] If a qualified taxpayer acquires the major portion of a trade or business or unit of a trade or business of another taxpayer, the employment relationship between a qualified full-time employee and a qualified taxpayer shall not be treated as terminated if the employee continues to be employed in that trade or business.[23]

NEC Recapture

If the employment of any qualified full-time employee is terminated[24] within the first 36 months of employment, the tax of the qualified taxpayer shall be increased for the tax year in which the employee was terminated by the total amount of all NEC allowed for all tax years attributable to the payment of qualified wages to the terminated employee.[25]

Recapture is not required where employment is terminated in any of the following circumstances:[26]

- the employee voluntarily leaves the employment of the taxpayer,
- the employee becomes disabled and unable to perform the services of that employment,
- the termination was due to employee misconduct,
- there is a substantial reduction in trade or business operations of the qualified taxpayer,
- the terminated employee is replaced so as to create a net increase in both the number of employees and the hours of employment, or

21 An individual is "unemployed" for any period the individual does not have wages subject to California withholding, is not self-employed, and is not a registered full-time student at a high school, college, university, or other post-secondary educational institution. Sections 17053.73(b)(15) and 23626(b)(15).

22 Sections 17053.73(h) and 23626(h)(1). Taxpayers treated as related under Internal Revenue Code ("IRC") sections 267, 318, 707, that are members of the same controlled group of corporations as defined by IRC section 1563(a) (modified by substituting "more than 50 percent" for "more than 80 percent"), or are under common control under principles that apply to controlled groups of corporations are considered related for these purposes. Sections 17053.73(h)(1)-(4), 23626(h)(1)(A), (B) and 23626(h)(2). Any allowable NEC is allocated based on the percentage of qualified wages paid by each member or related employer. Sections 17053.73(h)(3) and 23626(h)(1)(C).

23 Sections 17053.73(h)(5) and 23626(h)(1)(D).

24 The employment relationship is not terminated for purposes of NEC recapture by a mere change in the form of conducting the trade or business of the qualified taxpayer, if the employee continues to be employed in that trade or business and the qualified taxpayer retains a substantial interest in that trade or business. Sections 17053.73(i)(3) and 23626(i)(3).

25 Sections 17053.73(i)(1) and 23626(i)(1). There is no provision for prorating NEC recapture where employment is terminated within the first 36 months of employment. Thus, if an employee is terminated after 35 months of employment, it appears the entire amount of NEC attributable to that employee is subject to recapture.

26 Sections 17053.73(i)(2)(A)-(F) and 23626(i)(2)(A)-(F).

- the employment is seasonal employment and the employee is rehired on a seasonal basis.

Annual Certification Requirements

A qualified taxpayer must provide FTB with an annual certification of employment with respect to each full-time qualified employee hire for the previous tax year on or before the 15th day of the third month of the taxable year, and include information determined by the FTB to be necessary, including, the name, social security number, start date of employment and rate of pay for each qualified full-time employee employed by the qualified taxpayer.[27]

Comparison to the Enterprise Zone Hiring Credit

While similar to the Enterprise Zone Hiring Credit ("EZ Hiring Credit")[28] in many respects, the NEC differs in several significant ways, some of which are shown in the table below:

Requirement	*EZ Hiring Credit*	*NEC*
Claiming the Credit	May be claimed on an amended return.	Must be claimed on a timely filed original return.
Employee Verification	Vouchers must be obtained from local enterprise zone manager to verify qualified employee status.	Taxpayers must pre-register qualified employees with the FTB through the tentative credit reservation system.
Industry Limitations	Available to all businesses.	Some businesses ineligible.
Qualified Wages	Only wages that do not exceed 150 percent of minimum wage qualify.	Wages within the range of 150-350 percent of the state minimum wage qualify.
Increased California Employment	Amount of credit has no relationship to increase in California employees.	Credit is contingent on an annual increase in California employees.
Full-Time/Part-Time Employees	Part-time and full-time employees qualify.	Only full-time employees qualify.
Employed in Applicable Zone	Employee must perform 90 percent of services that relate directly to taxpayer's business in a zone, and 50 percent of such services must be performed within the zone.	50 percent of the employee services must be performed in a designated census tract or economic development area.
Carryover Period	No limit to carryover period. Credits may be carried over until exhausted.	Unused credit may be carried over for a maximum of 5 years.
Employee Qualification	15 categories of qualified employees.	Only 4 narrowly tailored categories of qualified employees.
Recapture	Termination of employment within 270 days of hire requires credit recapture.	Termination of employment within 36 months of hire requires credit recapture.

27 Sections 17053.73(e)(3) and 23626(e)(3).

28 Sections 17053.74 and 23622.7.

Zone Income	Credit utilization limited to income attributable to the enterprise zone.	No similar limitation.
Assignability of Credits	Assignable pursuant to section 23663. However, assignees must have income attributable to the zone to utilize the assigned credit.	Assignable pursuant to section 23663. The assignee is not required to have income attributable to a designated census tract or economic development area to utilize the assigned credit.

Concluding Remarks

The NEC is a complex credit and is quite different from the EZ Hiring Credit. It contains rigorous qualification requirements and imposes substantial reporting burdens on taxpayers that seek to qualify for the credit – with no assurance that those efforts will be rewarded.

For example, a taxpayer must request a tentative credit reservation from the FTB **for each new employee hired** generally within 50 days of the hiring date. Employers that hire year-round may be required to obtain tentative credit reservations numerous times every year as employees are hired, but will not have sufficient information to know if they qualify for the credit until the end of the taxable year. However, failure to request the tentative credit reservation for each new employee that "might" result in allowable NEC within the very short timeframe allowed may bar the taxpayer from claiming the NEC with respect to that employee. Thus, to preserve NEC eligibility, taxpayers that have already hired new California employees this year should promptly request a tentative credit reservation with the FTB for each of those employees that may be a "qualified employee" under the NEC.

The news is not all bad, however. While it may be more difficult to secure NEC than the EZ Hiring Credit, unlike the EZ Hiring Credit, the NEC is not limited to offsetting the net tax attributable to a particular zone, and may be assigned without the assignee being similarly subject to that limitation.[29] Taxpayers have long complained about this limitation on their ability to utilize EZ Hiring Credits, and the credit assignment provisions of section 23663 have provided little relief because an eligible assignee of EZ Hiring Credits must have net tax attributable to an enterprise zone to use the assigned credits.[30] Those complaints appear to have been addressed by the NEC.

Furthermore, the new California Competes Credit was enacted along with the NEC to replace the EZ Hiring Credit,[31] and is available beginning in 2014 to any taxpayer that is granted credit by the California Competes Tax Credit Committee – even to those taxpayers that have also claimed the NEC.[32]

There are still many unanswered questions about the NEC. For example, when and for what purposes will affiliates and other related parties be treated as a single taxpayer or as separate taxpayers? How may the credit be allocated amongst them? May such credit allocation be altered by credit assignment? The NEC statute and early FTB guidance are either difficult to reconcile or are silent on these points, so stay tuned for further guidance from the FTB.

29 FTB FAQ 6 and 10 under *Credit Usage and Carryover*. Section 23663 generally permits credits to be assigned to unitary affiliates. Please see our Client Alert of May 14, 2009, for details of the credit assignment provisions.

30 Id.

31 Enacted on July 11, 2013, Assembly Bill 93 includes the NEC, the California Competes Credit, and the elimination of the EZ Hiring Credit.

32 FTB FAQ 2 under *Miscellaneous*. See footnote 1, above for details on the California Competes Credit and the regulations pertaining thereto.

This material is not intended to constitute a complete analysis of all tax considerations. Internal Revenue Service regulations generally provide that, for the purpose of avoiding United States federal tax penalties, a taxpayer may rely only on formal written opinions meeting specific regulatory requirements. This material does not meet those requirements. Accordingly, this material was not intended or written to be used, and a taxpayer cannot use it, for the purpose of avoiding United States federal or other tax penalties or of promoting, marketing or recommending to another party any tax - related matters.

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