

SBE Ruling Eases Requirements to Claim California Enterprise Zone Hiring Credit

The SBE reversed the FTB, which had disallowed the disputed credits based on its interpretation of eligibility for the credit, which was based on employee eligibility under the federal Job Training Partnership Act.

Author: WILLIAM H. LABHART

WILLIAM H. LABHART is a principal in Labhart Miles Consulting Group, Inc., in San Jose, California. He practices in the state and local area, specializing in credits and incentives consulting in state income, franchise, sales, use, and other transfer taxes. He has served as a speaker for various professional organizations and has previously written for The Journal, where he also is member of the editorial advisory board. This article appears in and is reproduced with the permission of the Journal of Multistate Taxation and Incentives, Vol. 17, No. 8, Nov/Dec 2007. Published by Warren, Gorham & Lamont, an imprint of TTA. Copyright (c) 2007 Thomson/TTA. All rights reserved.

In the combined cases, *Appeal of Jessica McClintock*, No. 304497, and *Appeal of Jessica McClintock, Inc.*, No. 304512, on 8/14/07 the California State Board of Equalization (SBE), in a nonprecedential letter decision, reversed the Franchise Tax Board (FTB) and ruled that a worker hired by an employer in a California enterprise zone (EZ) does not have to be economically disadvantaged in order for the employer to be eligible to claim a hiring tax credit for that worker. In the ruling, the SBE unanimously upheld the taxpayers' claims, in tax years 1998 through 2001, for \$312,000 in tax credits for hiring 16 employees who were older workers, veterans, or high school dropouts. The overall EZ hiring credit, including the undisputed portion, was in excess of \$1.2 million. The FTB had disallowed the disputed credits based on the agency's interpretation of eligibility for the credit, which was based on employee eligibility under the federal Job Training Partnership Act (JTPA).¹

The FTB has recently faced several taxpayer challenges with regard to the EZ hiring credit, as well as other tax credits. The most notable of these disputes include: (1) *Appeal of Granite Construction Corp.*,² which involved qualified equipment under the state's now-expired manufacturer's investment credit; (2) *Appeal of Deluxe Corporation*,³ challenging the FTB's authority to review the underlying documentation applicable to previously approved EZ hiring credit vouchers; and (3) *Appeal of DiCon Fiberoptics, Inc.*,⁴ which concerned the FTB's authority to disallow employees previously found qualified by a local vouchering agent.⁵

The EZ Hiring Credit

The California enterprise zone hiring credit was created by the state legislature in the mid-1980s. Enterprise zones generally are designed to attract investment in economically depressed areas, and the hiring credit is one of the incentives California offers to

businesses that locate or expand in a zone. This franchise/income tax credit is also intended to encourage zone businesses to employ individuals who otherwise generally have difficulty finding work and/or who are economically disadvantaged. The employer can hire targeted workers, who can qualify as such under one of several categories.

The EZ hiring credit is 50% of qualified wages in the first year of employment, and decreases by ten percentage points annually, with a credit of 10% of qualified wages in the fifth and final year. "Qualified wages" is that portion of wages paid or incurred during the tax year that does not exceed 150% of the state minimum wage (\$11.25/hour based on the minimum hourly wage of \$7.50 effective 1/1/07). Currently, an employer who hires a qualified, full-time worker can claim a tax credit of approximately \$35,000 over the five-year benefit period. (The credit will increase as California's minimum wage is increased, beginning 1/1/08.) During the years at issue in the *McClintock* cases, the maximum credit per full-time worker was approximately \$30,000.

Certifying an eligible employee. To claim the EZ hiring credit, a taxpayer must apply to the local enterprise zone for a certification, or "voucher," which provides that a qualified employee meets the eligibility requirements specified in the statute. The taxpayers' application for certification must include the appropriate fee and must document the employee's eligibility. The voucher must be retained by the taxpayer and provided to the FTB on request. (This certification "process" is currently under great scrutiny and was addressed as part of some recently enacted legislative changes.⁶)

To qualify, at least 90% of the employee's services for the taxpayer during the tax year must be directly related to the conduct of the taxpayer's trade or business located in an enterprise zone; at least 50% of the employee's services must be performed in an enterprise zone; and the employee must have been hired by the taxpayer after the date of original designation of the area in which services were performed as an enterprise zone. In addition, a qualified employee must be an individual who, just prior to employment with the taxpayer, fit into *any one* of several specified categories, which include, among others, the following:

- (1) Chronically unemployed, including individuals at least 55 years of age who may have substantial barriers to employment by reason of age.
- (2) Involuntarily separated from the armed forces following active military duty, or a disabled veteran.
- (3) Unemployed due to a plant closure or substantial layoff.
- (4) A chronically unemployed seasonal or migrant worker.
- (5) A member of a federally recognized Indian Tribe or other group of Native American descent.
- (6) An ex-offender.
- (7) A resident of a federally defined "targeted employment area."
- (8) A person eligible for services under the federal Job Training Partnership Act or its successor, who is receiving, or is eligible to receive, subsidized employment, training, or services funded by such act. (Similar programs include the Workforce Investment Act of 1998 (WIA; codified at 29 USC section 2801 *et seq.*), which replaced the JTPA.)

At issue in the *McClintock* cases was the workers' California hiring credit qualification based on the workers' eligibility for the federal JTPA programs. As explained in the U.S. Congress's Conference Report to S.B. 2036 (H. Rep't No. 97-889, 9/28/82), JTPA section 1603, which concerned eligibility to participate in that Act's Adult Training Program, provided that such eligibility was limited to "economically disadvantaged individuals," but up to 10% of the participants could be "individuals who are not economically

disadvantaged if such individuals have encountered barriers to employment (including, but not limited to, individuals with limited English-language proficiency, displaced homemakers, teenage parents, older workers, veterans, offenders, alcoholics, addicts, school dropouts, or handicapped."

The *McClintock* Cases

Founded in the late 1960s, Jessica McClintock, Inc. is one of the premier clothing design houses headquartered in California. The designer sells nearly one million dresses annually, approximately 95% of which are manufactured in California. All 16 credit vouchers being disputed were issued for employees at the company's San Francisco headquarters, in an area that has historically been economically depressed and is in an enterprise zone.

The 16 vouchered individuals were employed in dress manufacturing or warehousing and, according to taxpayers' counsel, all faced barriers to employment, making them eligible to participate in the JTPA Adult Training Program. Many of the 16 were immigrants lacking a formal education, and the majority were more than 55 years of age.

The questions for the SBE. The three issues that were in dispute are as follows:

(1) Did section 1603 of the JTPA (discussed above) create a separate eligibility category for JTPA services? In contending that section 1603 is an eligibility category, the taxpayer relied on JTPA legislative history, California's EZ statutes, publications issued by the state Employment Development Department (EDD), and, most significantly, the U.S Department of Labor's interpretation of the federal statute.

(2) Is being an "older worker" (defined as at least 55 years of age) a "barrier to employment" under section 1603(c) of the JTPA statutes? The taxpayers maintained that being older is a barrier to employment, relying on an EDD form that states that older workers can qualify under section 1603(c).

(3) Did the taxpayers establish sufficient evidence to show that three of the employees in question were high school drop-outs, as defined by the JTPA statutes. The taxpayers had submitted employee job applications in which the applicants listed their highest grade completed and any degrees obtained. None of the three got past the 11th grade and none listed any degrees, not even a GED ("graduate equivalency diploma"). Given the self-explanatory nature of the employment application, the taxpayers did not address this issue during the hearing.

Taxpayers' View: JTPA Connection to the Hiring Credit

The issues being challenged in the *McClintock* cases pertained to the FTB's interpretation of the EZ hiring credit qualifying categories under the JTPA. The JTPA and its successor, the WIA, are programs designed, in part, to identify workers who are considered economically disadvantaged and who face barriers to employment.

A separate eligibility category. Regarding the first issue, the taxpayers detailed their position by explaining that section 1603 of the JTPA governs eligibility under the Adult Training Program. Subsection A, entitled "Eligibility for Services," relates to economic eligibility, stating in part, "except as provided in subsection C of this Section,

an individual shall be eligible to participate only if such individual is economically disadvantaged." The taxpayers focused on the key phrase, "except as provided in Subsection C," which subsection, as discussed above, concerned individuals who are not economically disadvantaged but have encountered barriers to employment. In their reading of the JTPA statute, subsection A relates to economic eligibility and subsection C relates to non-economic eligibility. In looking for additional authority, the taxpayers cited sources from both of the agencies that jointly administered the JTPA—the U.S. Department of Labor (DOL) and the California Economic Development Department. The instructions to an EDD application form, as well as a DOL response to another state's request for an increase in the allowable cap for participation, indicated that both subsections deal with eligibility. Thus, according to the taxpayers, these documents indicated that eligibility required only that the otherwise qualified individual encounter a barrier to employment, and need not also be economically disadvantaged.

LaShelle Wilson, the taxpayers' JTPA subject-matter expert witness, explained the federal legislative history and the changes made to the program subsequent to its original adoption. She also provided a detailed analysis regarding the "10% exception," which was raised as part of the discussion of qualifying categories. As noted above, while eligibility to participate in the JTPA program is generally limited to economically disadvantaged individuals, up to 10% of program participants can be individuals who are not economically disadvantaged if those individuals have encountered barriers to employment (which includes, but is not limited to, individuals with limited English-language proficiency, displaced homemakers, teenage parents, older workers, veterans, offenders, alcoholics, addicts, school dropouts, or the handicapped). The taxpayers maintained that their employees were covered by this seemingly open-ended list of qualifying, albeit not economically disadvantaged, categories.

Age as a barrier to employment. The second issue to be considered was whether being an "older worker" was a barrier to employment under section 1603(c). The taxpayers pointed to a directive issued to all JTPA service areas in California regarding the Act's application which stated that individuals that are not economically disadvantaged under Title 5 of the Older Americans Act (OAA) may be included because they are within one or more categories that face serious barriers to employment. Individuals qualified under the OAA are those age 55 and older.

The taxpayers went on to note that the EDD's explanation is tied to the statute and adds additional weight to their argument. The EDD details that such categories, i.e., "barriers to employment," may include individuals who are hard to serve or those such as displaced homemakers, veterans, etc. In other words, section 1603(c) does not provide an exhaustive list; rather, it is open-ended in order to provide EDD with some discretion. And in this instance, that discretion is used to classify older worker as facing serious barriers to employment.

In addition, the taxpayers pointed to the FTB's "Economic Development Manual," issued for guidance to its auditors in January 2005, 13 years after federal amendments to the JTPA. In that manual, FTB stated that the JTPA exception for "older worker" includes workers who are 55 years of age and older, and would be a qualifying category.

Employee job applications as documentary evidence. The taxpayers did not dispute the third issue, as it pertained to the documentation that the taxpayers' representative stated it had provided. The SBE did not focus on this issue either, and with its holding in favor of the taxpayer's full claim, the issue became moot.

The FTB's Arguments

FTB Tax Counsel Ann Hodges stated the FTB's position, as follows: The JTPA contained several different programs aimed at providing job training services to different segments of the population. The program at issue in *McClintock* was entitled "Training Services for the Disadvantaged—Adult and Youth." The employees at issue in this appeal had to be eligible for the training program in order to be qualified employees for purposes of the EZ hiring credit. In making her case the FTB Counsel quoted language from the JTPA statute, as follows: "...except as set forth in Subsection C of this Section [1603], an individual shall be eligible to participate in this program under this part only if such individual is (1) 22 years of age or older, and (2) economically disadvantaged."

The FTB reasoned that, by the very terms of the statute, the JTPA 10% language referred to an exception to eligibility and, therefore, an individual is eligible only if the individual is also economically disadvantaged. There was no dispute that these employees were not so disadvantaged. Thus, FTB contended that these employees were not qualified under the JTPA, and therefore could not be considered qualified employees for purposes of the EZ hiring credit.

The SBE's Opinion ... With a Little History

Board member Bill Leonard, a member of the California legislature at the time it was debating the EZ program, provided some historical background. The federal JTPA legislation, sponsored by Sens. Dan Quayle (R-Ind.) and Ted Kennedy (D-Mass.) in the early 1980s, was designed to create a targeted job training fund. Some expressed concern that the program might strain an already tight budget, so many limitations were placed upon it. Subsequently, it was discovered that very few individuals qualified under the program so reforms were instituted in the early 1990s, adding new categories to ease eligibility restrictions. At about the same time, significant layoffs were occurring in the aerospace industry, and "55 and older" became a priority category.

When California legislators Maxine Waters and Pat Nolan were crafting the EZ bill that is the subject of the *McClintock* appeal, they sought to increase the availability of the tax credit to encourage hiring but not extend benefits to those employers who were going to hire an individual anyway. Therefore, they decided to link the benefit to some "hard-to-hire" criteria, and since the criteria already existed in the JTPA program, they copied the JTPA list of qualifying categories. That is why, according to SBE member Leonard, the argument between "enrolled in" and "eligible for" JTPA is not relevant. All that an individual has to do to be technically eligible in a particular category is to be part of a hard-to-hire group—there is no need to be recruited or enrolled in the program. The only requirement was that the employer still had to prove and document that the person was JTPA eligible. This notion subsequently led to the need for more guidance and formal regulations, which, as noted above, were adopted, effective 1/1/07.

Based on this information, along with that provided by the taxpayers, the SBE members voted unanimously to approve the taxpayers' entire claim.

Conclusion

California's governing agency for the EZ hiring credit, the Department of Housing and Community Development, has released new regulations generally effective 1/1/07 (25 Cal. Admin. Code §8460 *et seq.*), updating and detailing the current procedures for issuing vouchers with regard to hiring credit qualification and providing more exact

definitions of the qualifying categories.⁷ Therefore, taxpayers must consider that the JTPA has expired, and the new EZ regulations now refer only to the WIA, the federal program that replaced the JTPA. Thus, the implications of the *McClintock* decision may be limited.

Because the JTPA program was superseded by WIA and is thus no longer in effect, the regulations exclude retroactive voucher applications for employees hired prior to July 2000 who may have qualified under the JTPA. Therefore, unless an employee hired prior to July 2000 has already obtained a determination of eligibility or was enrolled in JTPA, the Department of Housing and Community Development will not retroactively authorize an EZ hiring credit voucher for that individual. []

Notes:

¹

P.L. 97-300 (S.B. 2036, 10/13/82); codified at 29 USC section 1501 *et seq.*

²

Cal. State Bd. of Equalization, No. 301578, 11/20/06.

³

Cal. State Bd. of Equalization, No. 297128, 12/12/06, 2006-SBE-003. The Deluxe case was discussed in Hargett, Pieroni, Kos-Read, and Lockman, "Claiming California Enterprise Zone Credits: Be Prepared for the Changes," 17 J. Multistate Tax'n 8 (June 2007). We understand the taxpayer has filed an appeal of the SBE's ruling in state court.

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Cal. State Bd. of Equalization, No. 209708, 2/8/05.

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In each of these cases, the taxpayer was represented by Marty Dakessian, Esq. (Dakessian & Assoc., P.C.), who also represented the taxpayers in the *McClintock* matter. The *McClintock* taxpayers also enlisted the representation of Jon Sperring, an accountant with PricewaterhouseCoopers LLP and also an attorney, and LaShelle Wilson, general counsel for California Credits Group, LLC, a consulting firm specializing in California Enterprise Zone credits, and serving here as an expert witness with regard to the JTPA.

⁶

See Hargett, Pieroni, Kos-Read, and Lockman, *supra* note 3.

⁷

The regulations also were noted in Hargett, Pieroni, Kos-Read, and Lockman, *supra* note 3.