

# **FIRST CALIFORNIA ENTERPRISE ZONE TAX CREDIT CASE DECIDED BY BOE**

*By Chris Micheli*

## **Introduction**

For several years, the Franchise Tax Board (“FTB”) has been engaged in an aggressive effort to audit taxpayers claiming California Enterprise Zone (“EZ”) tax credits with particular attention to the hiring tax credit. In that effort, the FTB has routinely disregarded “vouchers” (under the statute, they are termed “certifications”) for eligible employees used by businesses to claim the sliding scale hiring tax credit. The vouchers are issued by the local Enterprise Zone Manager, who is charged by statute to verify employee eligibility and issue the certification.

In the first decided case involving any of the EZ tax credits, the State Board of Equalization (“BOE”) issued a ruling in the *Appeal of Deluxe Corporation* (Case # 297128). In this 3-2 split decision, which was issued on December 12, 2006, the BOE determined that the Franchise Tax Board has the authority to review the documentation and determination made by the local EZ Manager. As a published decision, the BOE determination serves as a precedent for interested parties.

## **BACKGROUND ON THE EZ PROGRAM**

The California Enterprise Zone Program is intended to provide state and local incentives for businesses to invest and locate in economically distressed areas of the state (See Government Code Sections 7070, et seq.). State law currently authorizes forty-two enterprise zones in California. In addition, the law allows existing zones to expand up to 15% in geographic size.

The legislative purpose of the EZ Program is to “stimulate business and industrial growth in the depressed areas of the State.” The other purposes are to establish a 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.” The California Housing & Community Development Department (“HCD”) administers the EZ Program under the Government Code.

EZs are competitively designated based upon distress criteria (primarily poverty and unemployment levels determined at the census tract level) and the local government’s capacity to carry out an economic development program, including marketing, financing, and local incentives. EZs are designated for 15 years.

## **Tax Benefits of the EZ Program**

The tax benefits of being in an EZ are that businesses located therein may receive individual or corporate state tax incentives. Businesses can also receive local incentives, including local regulatory relief (e.g., reduced permit processing time and fees). EZ state tax benefits include the following:

- Credit for hiring certain disadvantaged individuals; qualified hires must fall within one of 14 categories, such as economically disadvantaged, dislocated workers, veterans, or individuals receiving public assistance. Credits are 50% for the first year of wages, 40% of second year wages, 30% of third year wages, 20% of fourth year wages, and 10% of fifth year wages. The maximum credit is about \$32,000 per qualified hire over a 5-year period.
- Net operating losses - 100% of losses can be carried over for 15 years. No carryback is permitted.
- Credit for sales/use tax paid on the first \$1 million in purchases (for individuals and businesses taxed under the personal income tax law) or first \$20 million (for corporations) for equipment used in manufacturing, processing and related activities.
- Business expense deduction - 40% of property costs (personal property, equipment, and furnishings) can qualify as a business expense, rather than as a capital expense subject to depreciation.
- Net interest deduction for lenders, based upon the net interest received from loans made to EZ businesses.

### **Case Background**

Many taxpayers have found themselves in audits and protests over EZ hiring tax credit claims. Now, a number of taxpayers are filing protests at the FTB and appeals with the BOE, which has administrative appellate jurisdiction over FTB determinations. If these taxpayers prevail, the FTB has no appeal rights. If these taxpayers lose, they may still pursue the issue by filing a lawsuit in superior court.

At its January 31, 2006 oral argument hearing, the BOE heard the first taxpayer challenge of the FTB's blanket rejection of vouchers obtained for claimed eligible employees. This first case, involving the Deluxe Corporation, dealt with "voucher reliance". The second case coming before the BOE in the next few months deals with challenges to specific eligibility criteria for determining "eligible employees." The *Deluxe* appeal represents the first BOE hearing on the FTB's practices regarding EZ vouchers, as well as the BOE's first decision involving EZ tax credits. As such, the written decision in this case serves as a legal precedent for taxpayers and the FTB.

### **EZ Hiring Credit Statute**

While the hiring credit statute has several different components, the focus of the *Deluxe* appeal was on the certification requirement set forth in California Revenue & Taxation Code Section 23622.7(c). This section of the statute states, in its entirety:

(c) The taxpayer shall do both of the following:

(1) Obtain from the Employment Development Department, as permitted by federal law, the local county or city Job Training Partnership Act administrative entity, the local county GAIN office or social services agency, or the local government administering the enterprise zone, a certification that provides that a qualified employee meets the eligibility requirements specified in clause (iv) of subparagraph (A) of paragraph (4) of subdivision (b). The Employment Development Department may provide preliminary screening and referral to a certifying agency. The Employment Development Department shall develop a form for this purpose. The Department of Housing and Community Development shall develop regulations governing the issuance of certificates by local governments pursuant to subdivision (a) of Section 7086 of the Government Code.

(2) Retain a copy of the certification and provide it upon request to the Franchise Tax Board.

The Enterprise Zone Program, as instituted by the Legislature, contemplated a system where the FTB would be responsible for administering the tax credit, but also gave Enterprise Zones the authority to issue vouchers and make eligibility determinations of employees. Under Section 23622.7(c)(1), the taxpayer is required to obtain “a certification that provides that a qualified employee meets the eligibility requirements specified in clause (iv) of subparagraph (A) of paragraph (4) of subdivision (b).” According to this language, it is the certification itself that serves as valid proof that a “qualified employee” meets the requirements of the statute and the employer may claim the hiring tax credit.

Several years ago, the FTB recognized the obligation to defer to the then-Technology, Trade and Commerce Agency (which previously oversaw the EZ Program before HCD began to administer it) regarding vouchering matters: “The Franchise Tax Board administers the Enterprise Zone tax credits in accordance with the requirements of the Revenue and Taxation Code but is cognizant of the jurisdiction and needs of Technology, Trade and Commerce to administer the overall Enterprise Zone program, including the issuance of vouchers.” (Letter from FTB Executive Officer Gerald Goldberg to TT&C Agency Secretary Lon S. Hatamiya, June 25, 2002.)

In this letter, Mr. Goldberg further stated that “[I]f the taxpayer obtains a voucher from an appropriate agency, the Franchise Tax Board will consider it sufficient certification that the identified employee meets the statutory criteria. Absent a voucher, the credit will be denied.”

### **Taxpayer’s Arguments**

In *Deluxe*, the taxpayer argued that it had complied with the plain language of the EZ hiring tax credit statute; the legislative intent supported the taxpayer's interpretation of the law; and, the FTB failed to follow its longstanding policy of accepting vouchers obtained by taxpayers from the local EZ Managers.

Moreover, the taxpayer argued there was no evidence supplied by the FTB that any vouchers obtained were “inappropriately issued” (a new term used by the FTB to reject the local EZ Manager’s determination). This is an important point because the FTB essentially took the position that it has the right to disregard previously-issued vouchers by the local EZ based upon its belief that the vouchers might have been “inappropriately issued” by the EZ Manager and the FTB had continued to imply that there was wrongdoing in this case in obtaining some vouchers. Yet, there was never any proof offered to justify this position.

### **FTB’s Arguments**

Publicly (as reflected in the briefs the FTB submitted in connection with the *Deluxe* appeal) the FTB took the position that: (1) it is entitled to subject taxpayers to its own set of documentation requirements; (2) it has the statutory authority to disallow any vouchers for any reason; and, (3) all of the vouchers at issue in this appeal must be called into question because they were issued by the City of Oakland (which failed an initial audit by HCD and was forced to modify its vouchering practices, among other problems addressed; that occurred and Oakland received a positive evaluation by HCD thereafter).

### **FTB Second-Guessing Permitted**

At its January 31, 2006 appeal hearing, the 5-Member BOE Board voted 4-1 that the FTB does, in fact, have the authority to reject the local EZ Manager’s determination, to “look behind the voucher” (i.e., review the documentation supplied by the taxpayer to obtain the vouchers), and to make its own conclusion whether the documentation provided by the taxpayer was sufficient to prove eligibility for the tax credit.

Thereafter, the BOE instructed the taxpayer to provide to the FTB staff within 30 days the requested documentation to prove that the vouchers previously obtained (and challenged by FTB in this case) were indeed properly granted to the taxpayer by the local EZ Manager. Then, the FTB had 30 days to review those vouchers and the supporting documentation, and made its determination.

Finally, within 30 additional days, the BOE staff was to review the documentation provided, as well as the taxpayer’s and the FTB’s legal and policy arguments justifying the acceptance or rejection of the disputed vouchers. This final review took much longer than expected, and the written opinion was prepared. As such, the 5-Member Board was presented with this matter at its December 12, 2006 hearing.

### **BOE’s Written Ruling**

At the December hearing, the BOE Board decided that 15 of the 43 challenged vouchers were valid and 28 vouchers were ruled invalid. The Board voted 3-2 in this regard. The Board adopted on a 3-2 motion (voting aye were Mandel, Yee and Chiang; voting no were Parrish and Leonard) a written opinion that essentially determines that the “FTB has the authority to review the validity of the vouchers and disallow” those that are challenged.

This written decision is consistent with the Board’s verbal ruling from its January hearing that the FTB has authority to “audit behind the voucher” and challenge the determination of the local EZ Manager. During the discussion of this opinion on December 12, the Board Members noted that the BOE “also has authority to review the FTB’s determinations.” As such, the BOE will begin hearing individual appeals from taxpayers denied their vouchers by the FTB.

In making these determinations, the BOE did not provide any guidance to taxpayers and the FTB. While one Board Member stated her opinion that the 43 vouchers at issue in this case “have not been substantiated,” a motion to deny all of the pending vouchers was defeated on a 2-3 vote. Instead, the Board voted 3-2 (with Parrish, Chiang, and Leonard voting aye) to uphold the issuance of 15 vouchers. In addition, the Board voted 3-2 (with Chiang, Yee and Mandel voting aye) to deny the remaining 28 vouchers. As a result, the taxpayer was granted 15 of the 43 challenged vouchers.

Unfortunately, the BOE decision does not really provide guidance to taxpayers regarding what standards will be used to determine whether the vouchers were properly issued. Hence, all forthcoming appeals to the BOE will likely be judged on a case-by-case basis. There was discussion among the BOE members and the staff regarding the recent adoption by the Housing & Community Development Department of its voucher regulations. BOE staff noted that there are extensive rules now for the issuance of vouchers under the specified eligibility requirements. However, those regulations are effective for vouchers issued after November 27, 2007.

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*Chris Micheli is an attorney and a registered lobbyist with the Sacramento governmental relations and advocacy firm of California Strategies & Advocacy, LLC, where he specializes in tax legislative and administrative matters. He can be reached at (916) 266-4575 or [cmicheli@calstrat.com](mailto:cmicheli@calstrat.com).*