

Firm Advice



Demystifying California Enterprise Zones (EZ): Approaches to Minimizing Risk

by John Choi, CPA, JD

Does this sound familiar? Your client recently hired a consulting firm to conduct an EZ study for their business. As a result, they will be getting back significant tax refunds from the State of California because of the EZ program. The good news is that your client will most likely receive a substantial refund from California. The bad news is that the previously unclaimed EZ program refund may not make you look good as their CPA.

And worse, you may have liability issues, especially if your client was entitled to additional refunds beyond the four-year statute of limitation for California. Because your client will not be able to claim the closed years' EZ program refunds from California, your client could seek the refunds from your firm.

If this scenario does not sound familiar to you, then consider yourself lucky. There is a high probability that one of your clients is located or investing in businesses located in an EZ designation or other similar program designations.¹ The reason for the high probability is simple: there is a large geographical area in California that has these tax incentive designations. So it could simply be a matter of time before you encounter this situation, unless you take a proactive approach to minimize your exposure. While this article focuses on the EZ hiring credit, keep in mind there are other similar programs, which may affect your clients.

The best way to minimize your exposure to the EZ is to educate all your firm employees about the program, identify the clients that could potentially benefit from the EZ incentives, and develop some safeguard measures to insure eligible clients receive the information they need to claim the available EZ incentives. While this article is not intended to satisfy all these requirements, it is a step in the right direction.

FOOTNOTES

1. Local Agency Military Base Recovery Area (LAMBRA), Targeted Tax Area (TTA), and Manufacturing Enhancement Area (MEA)

EZ Program Basics

The California EZ program is a state government initiative designed to stimulate job creation and economic development in certain economically depressed areas. Currently, there are 42 EZs authorized by statute. Most of the EZs were established in the late 1980s and early 1990s. More recently, however, there have been three new designations made.² These designations provide significant opportunities for businesses located in the EZ, since designations are generally good for 15 years with an opportunity for a 5-year extension period. Because some of the EZ incentives decrease with the age of the EZ designation, firms located on or around the newly designated EZ should become familiar with available EZ incentives and inform clients who could potentially benefit as soon as possible.

To qualify for the potential benefits of the EZ program, a business must be located and doing business in an EZ or must invest by lending money to other trade or business solely in the EZ for business purposes within

the EZ. To determine if a particular business is in an EZ, click on the link <http://www.hcd.ca.gov/fa/cdbg/ez/enterprise/index.html#maps> and check the address of your clients business against the "street" link of a particular EZ. If your client's business is in an EZ designation, then it automatically qualifies for benefits. The benefits can be substantial to your client and potentially detrimental to your firm if not considered.

Benefits

There are five potential benefits to business owners located in an EZ or investing in businesses in an EZ:

1) EZ Hiring Credit. This is the most significant of the five benefits and will be discussed in depth later in this article. This credit is significant because of the amount of tax credits that it can potentially accumulate. For example, one eligible employee under this program can allow a business owner to claim over \$30,000 in state income tax credits over a five year period. The potential benefits are substantial when one factors in that the maximum tax rate for Individuals, General Corporations, and Bank and Financial Corporations are 10.3%,³ 8.84%, and 10.84%, respectively.

2) EZ Sales & Use Tax Credit (SUT). This credit allows businesses located in an EZ that purchased "qualified property" after the EZ designation date and for use in an EZ to claim a tax credit based on the amount of sales tax paid or accrued on the "qualified property".⁴ The amount of SUT is limited to qualified property purchases of up to \$1 million for individuals and \$20 million for a corporation. *(continued on next page)*

2. Modesto, Brawley, and Barstow. As of this article date, the street ranges of the three new designations have not been finalized.

3. This includes the additional 1% for taxpayers with taxable income in excess of \$1 million to fund the "Mental Health Services Funding, Expansion" as passed by Proposition 63.

4. CR & TC Sections 17053.70 & 23612.2

California EZ Credits *(continued)*

3) Net interest deduction. Unlike all other benefits, this one does not require a business to be located in an EZ. Instead, the deduction pertains to someone who has invested by lending money to a trade or business solely located within an EZ. The loan proceeds must be used only for the trade or business activities within the EZ, and the loan must be made after the EZ was designated. Additionally, the lender cannot have any type of ownership interest in the borrower's trade or business. If these criteria are met, then the interest earned by the lender is a deductible item for California purposes.⁵

4) 100% NOL Carryover. You may carryover an NOL for up to 15 years or until exhausted, whichever occurs first. However, in order to claim this benefit, taxpayers must make an election on the original return filed, and the election cannot be revoked without the written consent of the Franchise Tax Board. The only caveat is that the EZ NOL can only be applied against the EZ business income. Thus, if a client solely operates their business in an EZ, the election should be made. But, if a client operates both within and outside the EZ, then it may not be advantageous to make this election. To make an appropriate analysis, CPAs should estimate future income and complete Worksheet VI of Form 3805Z and compare the results to other NOL forms for CA.⁶

5) Business expense deduction. This allows businesses to expense up to 40% of the "qualified property" rather than capitalizing the asset. The amount of expense is limited and varies between \$20,000 to \$100,000, depending on the taxable year after designation.⁷ Similar to the 100% NOL Carryover benefit, taxpayers must make an election on the original return filed, and the election cannot be revoked without the written consent of the Franchise Tax Board.

EZ Hiring Credit

As referenced above, this is the most significant benefit and poses the most risk exposure to CPAs who do not claim the EZ Hiring Credit (HC) for clients who are located and doing business in an EZ. Again, overlooking the HC can be quite significant because it can potentially generate credits totaling over \$30,000 per qualified employee in a 5-year period.

Once it has been determined that your client is located in an EZ, the process of obtaining the HC is as follows:

- Determine which employees may potentially qualify the business for the HC.
 - Only employees hired after the EZ designation date will potentially qualify.

FOOTNOTES

5. Net interest is the full amount of interest earned, less any direct expenses incurred in making the loan, such as commissions paid to a loan representative, costs incurred in funding the loan, and other costs of the loan.

6. FTB 3805V, FTB 3805Q, FTB 3807, or FTB 3809, whichever applies for the client

7. CR & TC Sections 17267.2 & 24356.7

– Potentially qualifying employees must also (i) spend at least 90% of their work time on activities directly related to the EZ business; and (ii) perform at least 50% of all their work activities at a business located in an EZ.

- The employees hired after EZ designation date will then need to be screened to determine if they meet one of many eligibility criteria,⁸ all of which pertain to the time period prior to the current employer hiring the employee. Because there are many eligibility criteria, employee screening should be carefully reviewed to determine if the employee potentially qualifies for the EZ program.

- If an employee potentially qualifies under one or more of the eligibility criteria, then documentation supporting the qualification must generally be obtained from the employee.

- If an employee potentially qualifies, then submit an EZ Voucher Request Application⁹ (California Form TCA EZ1) with supporting documentation and applicable fees to the respective EZ coordinator. The hardest part about the HC is not the calculation but rather obtaining employee qualification through the EZ program. In essence, qualified employees must be certified by obtaining a voucher from local EZ coordinators. Each EZ has its own EZ coordinator, who will review the application. The voucher allows the employer/ your client authority to claim the HC.

- If a voucher is received and all other eligibility is met, then determine the amount of HC based on the qualifying employee's wage rate, number of hours worked and date of hire.

Qualified employees can generate HCs up to five years (60 months) from their date of hire, based on a 12-month period. Therefore, to obtain the maximum credit, it is important that the eligible employees be pre-screened as soon as possible after hire. For the first 12 months, they are entitled to 50% of their qualified wages as a tax credit; then 40% of their qualified wages the following 12 months; then 30%; 20%; until finally 10% in the final 12 months. Qualified wages are determined by multiplying number of hours worked during the year with their wage rate (wage rate is capped at 1.5 times the minimum wage).

Three Common Misconceptions

I. A common misconception heard from CPAs is, "My client does not qualify because they do not hire those types of people." Do not be trapped into thinking this way. From experience, any business, whether professional or not, located in an EZ will most likely have employees who qualify under one of many eligibility criteria.

In fact, it is extremely rare to encounter any business that did not have at least 20% of the employees qualify after being screened. This includes professional service businesses, including attorneys and accounting firms. Some industries can have as many as 60% of employees qualify after being

8. CR & TC Sections 17053.74 & 23622.7

9. Most EZs have their own version of the EZ Voucher Request Application.

screened. It's simply a matter of obtaining qualifying information from the employees—the process most consultants are selling to your client. Remember, it only takes one employee to potentially obtain over \$30,000 in tax credits over a 5-year period.

Others have mistaken the EZ program for the federal Work Opportunity Tax Credit (WOTC) and Welfare to Work (WtW) programs, which are incentive tax programs for federal purposes. With very few exceptions, these federal programs are generally for employees receiving public assistance. While this is one category that can qualify an employee for the EZ, it is one of many.

There are some CPAs who believe that the HC does not apply to their clients because the turnover rates of employees are so high that the recapture provision negates the benefit of the HC. While there is a recapture of HC if an employee does not work a certain period of time, there are also many exceptions to the recapture provisions. And under just about all circumstances, your client will meet one of those exceptions.

As a former Franchise Tax Board (FTB) employee, setting policies and procedures for various tax issues including EZ, this CPA can assure you that the recapture provision was mostly put in place to counter any abuse in the EZ program. It prevents employers from abusing the EZ program by simply hiring, firing, and re-hiring employees to take advantage of the greatest amount of the HC, which is the first 12 months of employment.

II. A second common misconception is that once a voucher is received from the EZ coordinators, this voucher guarantees that the HC can be claimed. In fact, most consultants that specialize in the EZ program are selling your client on this point. The voucher is not a guarantee.

Some due diligence is still needed because of the so-called “50% rule”: a qualified employee must work within the EZ designated zone at least 50% of the total work time. This can be easily defined for one client and not so easily defined for another. The bottom line is that the FTB will audit this issue. If you have a client that has offsite drivers or workers, make sure that the employees' place and time is appropriately documented to ensure that they meet the 50% rule.

Speaking of audits, the FTB is conducting more audits than ever regarding claims for refunds from the HC. According to the Executive Officer and published by the CalTax Newsletter, the FTB will perform “Discovery Audits” specific to EZ Hiring Credits due to the perceived abuse in the amount of credits claimed. “Discovery Audits” is a term the FTB uses to indicate that they believe there is a non-compliance issue with taxpayers. This means that the FTB will target these files and audit them for a period of time.

The FTB perceives that some consultants are over-aggressively claiming HC for their clients. The perception might have some validity especially since most consultants are paid on a contingency basis.

III. A third common misconception is that getting the most HC is always the best solution for the client. This is not always true. There are three different factors that can interrelate and cause a higher tax result to your

client instead of benefiting them: 1) the wage add-back provision; 2) the EZ apportionment factor limitation; and 3) the EZ apportionment factor limitation per each separate EZ.

The wage add-back provision requires that the total HC gets added back to income for California purposes, which increases taxable income but allows your client to take the HC against the net CA tax. However, the amount of the HC may be limited because of the EZ apportionment factor limitation.

The EZ apportionment factor limits the HC so that the credits can only be applied against the EZ business income, which generally is not a problem if your client operates in one location in an EZ. However, the EZ apportionment factor might severely limit HC benefits if most of the client's taxable income is generated outside of the EZ.

Unlike the apportionment formula of a multi-state company, the apportionment for EZ is a two-factor formula: property and payroll. Without getting too technical, the formula basically takes the property and payroll of the EZ and takes a ratio against total property and payroll of all California locations. It then multiplies this ratio to total California tax, which is the EZ business income tax portion that can be reduced by the HC.

Potentially worse is that the EZ business income limitation applies on a zone-by-zone basis. Thus, if a client has operations in multiple EZs, separate limitations must be computed on each EZ. This can severely limit the amount of HC that can be used to offset state income taxes. Meanwhile, the entire HC amount calculated is added back to income for CA purposes, creating a higher tax base. There have been situations, especially if a client, such as a franchise, has many locations where taking advantage of the EZ program has cost them more money. The client will have an overall benefit in the long run, but sometimes it's pretty hard to explain that to the client.

Minimizing Risks

As stated before, the best way to minimize the risks to a CPA regarding the EZ program is to educate firm employees, identify clients potentially qualifying for HC and other credits, and develop some safeguard measures. Aside from this article, CPAs can better educate themselves about the EZ program by reviewing FTB Publication 3805Z, visiting the website for Housing and Community Development (www.hcd.ca.gov), which is the agency responsible for overseeing the EZ program, and contacting your local EZ coordinator for more details.

There are a few safeguard measures CPA firms can develop to minimize risk exposure from the EZ program. However, to do so the firm must decide whether it wants to either: 1) conduct EZ studies itself; 2) have the clients do it themselves with CPA firm just performing the calculations; or 3) team up with another firm that specializes in the EZ program.

Whatever the CPA firm decides, all firms should strongly consider disclosing to clients doing business in an EZ that they may be entitled to certain

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California EZ Credits *(continued)*

tax benefits for either being located in an EZ or investing in businesses doing business in an EZ. Of course, to properly inform your client, find out whether or not your client is located in an EZ. (See the section of this article on “EZ Program Basics.”)

CPA firms might consider modifying their engagement letters for that disclosure. Sample engagement letter language is included at the end of this article. By being educated about the EZ program, CPAs can explain to their clients that personal information provided by employees is the basis of the HC calculation. As a result, the CPA firm may or may not be able to fully conduct the EZ studies.

Three Options for Minimizing Risk

1) CPA firm conducts the EZ study itself

One option for the CPA firm is to build an expertise in the EZ program and conduct the study itself. However, to do so the firm must understand not only the rules and regulations, but also the process of ensuring that the eligible employees do qualify based on documentation, which is probably the hardest part about the program. CPA firms must weigh the benefits of doing the studies themselves by “reinventing the wheel” against potential exposure of not being thorough in identifying qualified employees. If a CPA firm does an HC study for a client but does not identify all qualifying employees, the CPA firm has liability exposure for the HC that was potentially available (through the qualifying employees) but was unclaimed.

Another consideration about the EZ HC is that the eligibility criteria for qualifying the employees are quite sensitive in nature and thus might be difficult to ask about, let alone obtaining documentation to support such facts.

2) The clients conduct the EZ study themselves

At a minimum, your firm might want to have the clients conduct the study themselves and ensure that all potentially qualifying employees are (i) identified and (ii) certified by an EZ coordinator. Using the qualifying employee data developed by the client, your firm would then calculate the HC.

Having the client conduct the EZ study themselves with your firm calculating the credit based upon the client provided data presents the highest potential liability exposure to your firm. Your firm must still possess a significant level of HC expertise to guide the client’s employee study and address the client’s questions.

Additionally, clients are frequently adverse to posing sensitive questions to their employees regarding personal information necessary to determine whether the employee is a qualifying employee. Such questions would inquire regarding the employee’s economic status as well as past felony convictions. Research has shown that employers who attempt to do the

employee study themselves are not successful in maximizing the benefits. If your client did an incomplete employee study or certification causing an under-claimed HC, the client might allege that your firm improperly instructed the client and/or was otherwise responsible for the under-claimed credit.

Because having the client conduct their own EZ study poses such large liability exposure to your firm, it is very important to have a very specific engagement letter which describes (i) the specific services your firm will provide as part of the EZ study (generally a calculation of the EZ credit based upon client provided employee data); (ii) the specific data the client will provide for the engagement; and (iii) a statement indicating that because your firm is calculating the EZ credit based upon client provided employee data, the client retains financial responsibility if incorrect or incomplete employee data causes less than the total available EZ credit to be claimed.

3) Team up with specialists in the EZ program

Last but not least, a CPA firm can team up with a consulting firm and refer the EZ work to the consultant. This is by far the safest route. Not only are you not “reinventing the wheel” on the EZ, but by getting connected with a good network of professionals, you are minimizing your exposure and maximizing the benefits for your client.

Just like CPA firms that refer out financial audits, it would be wise to refer out the EZ studies. By doing so, the firm is acknowledging that it is not expert in the EZ field, is willing to look out for the interests of its clients, and is minimizing its risk exposure from the EZ program.

John Choi, CPA, JD, of Professional Solutions Group LLC, has more than 12 years of experience in tax consulting and has spent 8 years with the Franchise Tax Board. He is considered a specialist in business incentive tax credits and income tax issues for flow-through entities. He has a Bachelor of Science degree in accountancy from the University of the Pacific and a Juris Doctorate degree in tax from the McGeorge School of Law. For further questions regarding the EZ program, please contact Mr. Choi at (916) 355-1299 or email him at john@prosolutionsllc.com.

Sample Engagement Letter Language is available on the CAMICO Members-only Extranet for two types of letters:

- 1) a general letter for clients doing business in Enterprise Zones; and
- 2) a letter for clients performing employee EZ studies.

Go to the Risk Management Resource Library, click on Newsletter Library, IMPACTs, IMPACT 69, and “Demystifying California Enterprise Zones.” The sample letter language is at the end of the article.

CAMICO members can always call 1.800.652.1772 for assistance.