Date of Hearing: April 4, 2022

ASSEMBLY COMMITTEE ON REVENUE AND TAXATION
Jacqui Irwin, Chair

AB 2035 (Villapudua) – As Amended March 29, 2022

FOR TESTIMONY ONLY

2/3 vote. Tax levy. Fiscal committee.

SUBJECT: Taxation: credits: California New Employment Credit

SUMMARY: Allows restaurants, theaters, and bars that are not considered small businesses to claim New Employment Credit (NEC). Specifically, **this bill**:

1) Allows the following employers to claim NECs, even if they are not "small businesses":

   a) Employers that are primarily engaged in providing food services (restaurants);

   b) Employers that are theater companies and dinner theaters (theaters); and,

   c) Employers that are primarily drinking places for alcoholic beverages (bars).

2) Changes the NEC's "qualified full-time employee" definition by:

   a) Removing the provision that requires a "qualified full-time employee" to receive starting wages that are at least 150 percent of the minimum wage;

   b) Replacing the requirement that qualified full-time employees must be paid qualified wages by a qualified taxpayer for services not less than an average of "35 hours per week" with "30 hours per week";

   c) Providing that qualified full-time employees must be paid qualified wages by restaurants, theaters, and bars for services not less than an average of only "25 hours per week";

   d) Allowing more veterans to qualify by changing separated from the U.S. Armed Forces within the previous "12 months" to "24 months";

   e) Allowing people who received six weeks of unemployment compensation within the 36 months preceding the commencement of employment with the qualified taxpayer ; and,

   f) Allowing people who, preceding the commencement of employment with the qualified taxpayer, are a qualified supplemental nutrition assistance program benefits recipient, as defined in Section 51(d)(8) of Title 26 of the United States Code.

3) Amends the definition of "qualified wages" used to compute the amount of credit from "150 percent of minimum wage, but does not exceed 350 percent of minimum wage" to "100 percent of minimum wage, but does not exceed 300 percent of minimum wage."

4) Applies all the changes made by this bill for taxable years beginning on or after January 1, 2023.

EXISTING LAW:

1) Conforms to federal law on the deduction of common business expenses. Federal law allows a business expense deduction if the expense is both ordinary and necessary. An ordinary expense is defined as an expense that is "common and accepted" in a taxpayer's trade or business. A necessary expense is defined as an expense that is "helpful and appropriate" for the taxpayer's trade or business. An expense does not have to be indispensable to be considered necessary. Taxpayers may generate expenses for salaries. (See FTB Publication 984; IRS Pub. 587; IRS Pub. 535.)

2) Allows various tax credits under the Personal Income Tax (PIT) Law and the Corporation Tax (CT) Law generally designed to encourage socially beneficial behavior or provide relief to taxpayers who incur specified expenses. Tax credits provided under the PIT Law and the CT Law have included credits for other taxes paid, investment credits, research credits, job creation or hiring credits, environmental credits, economic development credits, historic property credits, land conservation credits, and housing credits.

3) Establishes the NEC in the PIT Law and CT Law for taxable years beginning on or after January 1, 2014, and before January 1, 2026, which is an income tax credit for qualified taxpayers that hire a qualified full-time employee who generally has barriers to employment within a designated census tract or economic development area. (Revenue and Taxation Code (R&TC) Sections 17053.73, 23626.)

4) Requires any bill introduced on or after January 1, 2020, that authorizes a new tax expenditure, to contain all of the following:

   a) Specific goals, purposes, and objectives that the tax expenditure will achieve;

   b) Detailed performance indicators for the Legislature to use when measuring whether the tax expenditure meets the goals, purposes, and objectives stated in the bill; and,

   c) Specified data collection requirements to enable the Legislature to determine whether the tax expenditure is meeting, failing to meet, or exceeding those specific goals, purposes, and objectives. (R&TC Section 41.)

FISCAL EFFECT: Pending

COMMENTS:

1) The author has provided the following statement in support of this bill:

> The critical hospitality sector in California continues to experience financial turmoil in the wake of the pandemic despite previous helpful programs from our state and federal

governments. Restaurants and the hospitality industry at large need a program that specifically targets hiring assistance in regions with high unemployment. The NEC Program offers a proven track record of assisting California-based companies in this very issue.

Reports show that many restaurant/bar revenues are still less than 50% of normal because of their proximity to downtown and reliance on workers returning to the office. 37% of restaurants reopening in California are unable to pay rent and 350,000 jobs remain unfilled in the industry. The proposed legislation will extend the NEC Program to allow this industry, which is so critical to our overall economy, to benefit from this employment and tax assistance.

2) Committee Staff Comments:

a) *What does this bill do*? Starting with the 2023 taxable year, this bill expands the group of "qualified taxpayers" for the NEC by including restaurants, theaters, and bars that are not small businesses. This bill expands the pool of "qualified full-time employees" for the NEC by:

i) Removing the starting wage requirement;

ii) Reducing the paid hours per week requirement from 35 hours per week to 30 hours per week;

iii) Reducing the paid hours per week requirement more favorably for restaurants, theaters, and bars owners from 35 hours per week to 25 hours per week;

iv) Expanding the pool of eligible military veterans;

v) Expanding the pool of applicants deemed to have been unemployed; and,

vi) Including people receiving qualified federal supplemental nutrition assistance program benefits.

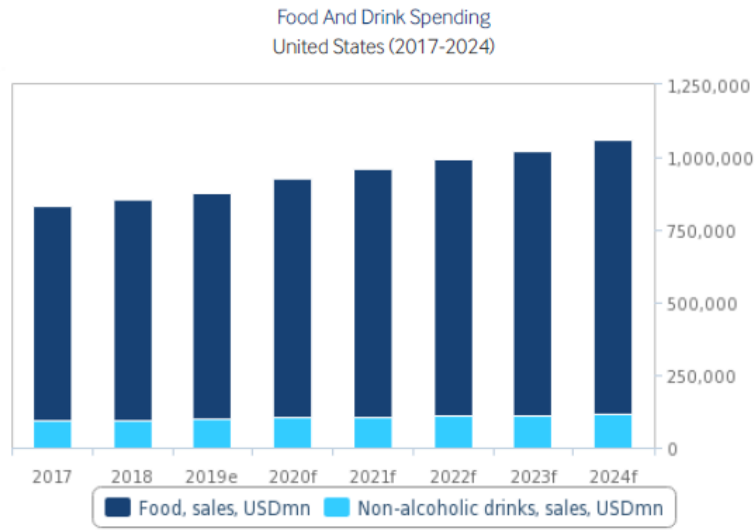
Additionally, this bill changes the definition of "qualified wages" used to calculate the amount of credit.

b) *Who benefits from this bill*? Restaurants, theaters, and bars that are not small businesses benefit from this bill because they are currently excluded. Under existing law, restaurants, theaters, and bars with adjusted aggregate gross receipts of less than $2 million are qualified to apply for the NEC. (R&TC Sections 17053.73(b)(14), 23626(b)(14).)

<u>Macro Considerations</u>

There is no doubt that the restaurant, theater, and bar industries were negatively impacted by the COVID-19 crisis and lock-downs. While California's job recovery has been stronger than expected, jobs in the accommodation and food service sectors are still below pre-COVID levels.[1]

Fortunately, forecasts for at least some industries appear to be better. According to a report, food spending is forecasted to grow by an average annual growth rate of 3.4% year-over-year during the 2021-2024 period and the "US drinks" sector is forecasted to continue on a positive growth trajectory in 2021 with alcoholic drinks consumption accelerating and non-alcoholic drinks spending still posting positive growth.[2]



e/f = Fitch Solutions estimate/forecast. Source: BLS, Fitch Solutions

However, the profit margins of many industries are at risk from rising costs associated with supply chain disruptions, inflation, and, notably, labor shortages.[3]

<u>Micro Considerations</u>

Under current law, NECs already help small businesses hire individuals who have employment barriers. However, this bill benefits big businesses like fast food franchise chains by allowing them to be qualified to receive NECs. Recently, a large fast-food company reported a net income of around $600 billion (84% year-over-year growth) for the 2021 year. This company noted "difficulties in hiring qualified full-time employees and increases in the cost of labor could adversely impact our business and profitability."

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[1] Bohn, S., Mejia, M., & Lafortune J. (2022). *California's jobs recovery has been stronger than we thought*. Public Policy Institute of California. https://www.ppic.org/blog/californias-jobs-recovery-has-been-stronger-than-we-thought/
[2] Fitch Solutions Group Limited. (2021). *United States Food & Drink Report includes 5-year forecasts to 2024*.
[3] Vesoulis, A. (2022). "Profit Doesn't Exist Anymore." restaurants that barely survived COVID-19 closures now face labor, inflation and supply chain crises. *Time.Com*.

This bill may potentially help big fast-food companies with sizeable net income use NECs to address the rising labor cost and maintain profits.[4]

c) *The original intent of the NEC program was to exclude restaurants, theaters, and bars that are not small businesses and reward employers hiring for full-time positions*: California comprehensively overhauled its "Enterprise Zone" program in 2013 and replaced it with three new tax programs: a Manufacturer's Sales Tax Exemption, NEC, and California Competes. [AB 93 (Committee on Budget), Chapter 69, Statutes of 2013; SB 90 (Galgiani), Chapter 70, Statutes of 2013.][5] Existing law explicitly excludes restaurants, theaters, and bars that are not small businesses from being eligible to receive NECs. Existing law also explicitly requires qualified taxpayers to pay wages for an average of 35 hours per week instead of 30 or 25 hours per week to qualify for NECs. This bill overhauls the original intent of the NEC, especially as it relates to the type of businesses that qualify and the incentive for full-time employment.

d) *Even with this bill, the NEC is still complex*: This bill allows restaurants, theaters, and bars with large gross receipts to apply for the NECs. However, this bill does not alleviate access to NECs for smaller restaurants, theaters, and bars. Even under this bill, small businesses may not realize enough economic benefit from the NECs to justify the cost of finding and hiring a competent tax professional to assist with their application for NECs. While bigger restaurants, theaters, and bars may have the economies of scale to justify the cost related to hiring a tax professional, many smaller businesses do not have the time and resources.

The NEC program is well intentioned, but its requirements and rules for receiving the credit may be complex and burdensome for small businesses. To highlight the complexity and difficulty of the NEC program, Committee staff prepared the below summary of the requirements and rules taxpayers must follow to apply for NECs.

<u>Qualified Taxpayer</u>

To obtain an NEC, a qualified taxpayer must:

i) Hire a qualified full-time employee on or after January 1, 2014;

ii) Pay qualified wages attributable to work performed by the qualified full-time employee in a designated census tract or economic development area;

iii) Receive a Tentative Credit Reservation from the Franchise Tax Board (FTB) (within 30 days of complying with the Employment Development Department (EDD) new hire reporting requirement) for that qualified full-time employee;

iv) Certify annually each qualified full-time employee;

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[4] Chipotle Mexican Grill, Inc. (2022). Form 10-K 2021. Chipotle Mexican Grill, Inc. https://ir.chipotle.com/sec-filings

[5] Weatherford, B. (2018). *The 2018-19 Budget: California hiring tax credits*. Legislative Analyst's Office. https://lao.ca.gov/Publications/Report/3784#Existing_New_Employment_Credit

v) Be an employer engaged in a trade or business within a designated census tract or economic development area;

vi) Not be engaged in any excluded businesses, including temporary help services, retail trades, those primarily in food services, alcoholic beverage places, theater companies, dinner theaters, casinos, and casino hotels unless the business is considered a small business;

vii) Not be engaged in a sexually-oriented business; and,

viii) Hire an individual that is a qualified full-time employee that works at least an average of 35 hours per week and meets other specified wage requirements.

Qualified full-time employee

A qualified full-time employee is an employee who meets at least one of the following five criteria:

i) Is unemployed for the six months immediately preceding employment;

ii) Is a veteran who has not been employed since separation from service;

iii) Is a recipient of the federal earned income tax credit for the previous taxable year;

iv) Is an ex-offender immediately preceding employment; or,

v) Is a recipient of CalWORKS or general assistance immediately preceding employment.

Amount of NEC

The credit is based on 35 percent of qualified wages, or wages between 150 percent and 350 percent of minimum wage. The wage range will increase over time due to increases in the minimum wage rate.

Conditions for Generating and Claiming NEC

To generate an allowable credit, the qualified taxpayer must have a net increase in its total number of full-time employees working in California compared to its base year, both based on annual full-time equivalents.

To claim a generated credit on a tax return, the qualified taxpayer must have a tax liability to offset. Otherwise, the credit is carried forward for potential use for up to five taxable years after the year the credit was generated. NECs may be claimed in taxable years beginning on or after January 1, 2014, and before January 1, 2026.

e) *Floodgates principle*: If this bill were to be enacted, other businesses, such as those primarily engaged in retail trade services, may ask for a similar inclusion into the NEC program.

f) *Other policy solutions*? If the author wishes to expand the base of qualified taxpayers that are currently excluded from the NEC program, the author could also accomplish that goal by expanding the "small business" exception to include a greater share of struggling mid-size businesses. For example, the author could amend the bill to increase the adjusted aggregate gross receipts threshold to qualify for the "small business" exception from $2 million to $25 million.

If, conversely, the author wishes to increase the accessibility of the NEC programs for struggling small businesses that already qualify for the program, the author could amend this bill to allocate resources to the Taxpayer's Right Advocate in FTB to hire tax professionals to actively assists small businesses to apply for NECs and comply with the program rules. Merely sending out brochures and mentioning links to the FTB's website regarding the NEC program in outreach events may not be enough to help small businesses apply for this program.

g) *Policy on tax expenditures*: Both R&TC Section 41 and this Committee's policy require any tax expenditure bill to outline specific goals, purposes, and objectives that the tax expenditure will achieve, along with detailed performance indicators for the Legislature to use when measuring whether the tax expenditure meets those stated goals, purposes, and objectives. A tax expenditure bill will not be eligible for a Committee vote unless it has complied with these requirements. This bill is a tax expenditure bill because it provides a tax credit to a new group of taxpayers. This bill does not comply with R&TC Section 41 requirements because it does not outline the specific goals, purposes, and objectives that the tax expenditure will achieve, along with detailed performance indicators for the Legislature to use when measuring whether the tax expenditure meets those stated goals, purposes, and objectives.

In addition to the R&TC Section 41 requirements, this Committee's policy also requires that all tax expenditure proposals contain an appropriate sunset provision to be eligible for a vote. According to the policy, an "appropriate sunset provision" shall mean five years, except in the case of a tax expenditure measure providing relief to California veterans, in which case "appropriate sunset provision" shall mean 10 years. The amendments made by this bill are operative from January 1, 2023, to December 31, 2025. Therefore, this bill meets the sunset requirement.

REGISTERED SUPPORT / OPPOSITION:

Support

None on file

Opposition

None on file

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