



## GOVERNOR'S OFFICE OF BUSINESS AND ECONOMIC DEVELOPMENT

### INITIAL STATEMENT OF REASONS (ISOR)

Subject Matter of Proposed Regulations: California Competes Tax Credit (CCTC) Program

Sections Affected: Title 10, Chapter 13, Article 1, Sections 8000 and 8030.

Revenue and Taxation Code (Rev. and Tax. Code) Sections 17059.2(h) and 23689(h) authorize the Governor's Office of Business and Economic Development (GO-Biz) to prescribe rules and regulations as necessary to carry out the purposes of the CCTC Program.

#### **A. Background**

Governor Edmund G. Brown Jr. established the Governor's Economic Development Initiative (GEDI) by signing Assembly Bill 93 (Cmte. on Budget, Chapter 69, Statutes of 2013 (AB 93)) and Senate Bill 90 (Galgiani, Chapter 70, Statutes of 2013 (SB 90)) into law. GEDI is comprised of the Manufacturing Equipment Sales and Use Tax Exemption, New Employment Credit, and the CCTC. GO-Biz is responsible for implementation of the CCTC. The CCTC is a state-wide program available to both large and small businesses, with 25 percent of the available credit each year specifically reserved for small businesses. Section 1 of AB 93 makes it clear that the intent of GEDI is to attract and retain high-value employers while at the same time ensuring accountability for the state's job creation efforts and the effective use of taxpayer dollars.

As part of the emergency regulations adopted in February 2014, and permanent regulations adopted in February 2015, GO-Biz developed an application process to implement the tax credit and make determinations as to which taxpayers would be granted the tax credit based upon a competitive application process.

GO-Biz has operated the CCTC program for over two years, and through operation of the program, has identified areas of the program and existing regulations that should be clarified. In accordance with the process for proposing amendments to the CCTC regulations, this ISOR describes: why the amendments are necessary to carry out the CCTC program, enumerates the benefits anticipated from the regulatory action, includes any study or data upon which GO-Biz relied, and describes the reasonable alternatives considered by GO-Biz and its subsequent decision for rejecting those alternatives.

GO-Biz is not exempt from the rule-making process under the Administrative Procedure Act. As such, in order to effectively administer the CCTC program, GO-Biz is required to promulgate regulations. The CCTC regulations provide a framework for ensuring that only the most competitive applicants receive the tax credit. In awarding the credit, GO-Biz is required by statute to consider the following factors:

- (1) The number of jobs created or retained in the state;

- (2) The compensation paid or proposed to be paid to full-time employees, including wages and fringe benefits;
- (3) The amount of investment in the state;
- (4) The extent of unemployment or poverty where the business is located;
- (5) The incentives available to the business in the state;
- (6) The incentives available to the business in other states;
- (7) The duration of the business' proposed project and the duration the business commits to remain in this state;
- (8) The overall economic impact;
- (9) The strategic importance to the state, region, or locality;
- (10) The opportunity for future growth and expansion; and
- (11) The extent to which the anticipated benefit to the state exceeds the projected benefit to the business from the tax credit.

In order to systematically create a method in which to evaluate the eleven factors, GO-Biz decided to implement a two-phase evaluation process to determine the competitiveness of each application. The first phase consists of a quantitative evaluation which uses a cost-benefit formula to determine the most competitive applicants with the lowest cost-benefit ratio. The applicants with the lowest cost-benefit ratio are moved to phase II. The cost-benefit ratio compares the amount of tax credit requested by the applicant with the first three factors of the eleven factors, specifically: (1) the number of jobs created, (2) the wages proposed to be paid to new full-time employees, and (3) the amount of investment in the state. A goal of the CCTC program is to attract and retain jobs in California. Therefore, applicants that certify that their project would take place in another state, or some or all of their employees would be terminated or relocated out of state absent award of this credit, are automatically moved into phase II.

Phase II consists of a comprehensive evaluation, which includes the remaining factors described above. At the end of the evaluation process, GO-Biz negotiates and executes agreements with the applicants specifying what requirements or milestones must be met in order to earn a tax credit. GO-Biz then presents these agreements to the statutorily created California Competes Tax Credit Committee for approval or rejection at a public meeting.

To effectively implement the two phase evaluation process and the overall CCTC program, GO-Biz adopted five distinct regulatory sections under Chapter 13, Article 1 to provide the framework and process of how to administer the CCTC program. Specifically, GO-Biz created the following sections: (1) the definitions, (2) the tax credit, (3) the announcements of the deadlines and committee meetings, (4) the application process, and (5) Franchise Tax Board duties. This ISOR addresses the rationale for each of the proposed amendments to sections 8000 and 8030, the benefits, alternatives considered, and the reliance on any other third party data or study.

## **B. Discussion of Sections Affected**

### **(1) Section Affected: Chapter 13, Article 1, Section 8000 – Definitions.**

The proposed regulation amends Section 8000 to define the terms “high poverty area” and “high unemployment area” as they are used in the CCTC program. Additionally, it replaces the existing term “salary” as used in the CCTC program with the term “wage or wages” and further clarifies the definition of “wage or wages.” GO-Biz has determined that the current use of the word “salary” can lead to confusion as payments to both salaried and hourly employees are included in the current regulatory definition of “salary.” Since “wage or wages” is a broader term, GO-Biz finds that it is a more appropriate term to encompass compensation paid to both hourly and salaried employees. Considering that the term “wage or wages” is broad, many interpretations of the term could be used. As a result, there is need for a specification and clarification of the term “wage or wages” as used in the CCTC program. Without clarification, multiple definitions of the terms could be used leading to disparate results between similarly situated CCTC program applicants. Due to the potential for multiple definitions, GO-Biz decided to define the terms to give them specific meaning under the regulations. Each bullet-pointed term below has a new or amended definition. The explanation following the new or amended term is broken into five parts: (a) explanation of the issue being addressed by the new or amended definition, (b) anticipated benefits from this regulatory action, (c) factual basis/rationale, (d) underlying data GO-Biz relied on in creating the new or amended definition and, (e) the reasonable alternative definitions considered by GO-Biz and its decision for rejecting those alternatives.

- “WAGE OR WAGES” – DEFINITION

- a. Issue being addressed:

A major priority of the CCTC program is the creation of new full-time jobs. To that end, “full-time employees” are quantified on an “annual full-time equivalent” basis to more accurately account for a “full-time employee.” “Aggregate employee compensation” includes the amount of “wage or wages” that an employer will pay its new “full-time employees” calculated on an “annual full-time equivalent” basis in aggregate over a five year period. The existing definition of “salary” excludes various forms of non-guaranteed or variable compensation including tips, overtime, and bonuses. However, while the existing definition also excludes “other compensation of any kind,” it doesn’t specifically state that “commissions or stock options” are excluded from the definition. The amended definition replaces the term “salary” with “wage or wages” and explicitly states the term “wages or wages,” as used in the CCTC program, does not include “commissions or stock options.” While “other compensation” clearly includes commissions and stock options, because this question has arisen on more than one occasion, GO-Biz is proposing to add commissions and stock options to be explicitly excluded.

- b. Anticipated benefits from this regulatory action:

This definition of “wage or wages” ensures applicants have a clear understanding of the information that is being requested for purposes of the calculation of the phase I ratio. Additionally, information being provided becomes more consistent between applicants, allowing CCTC staff to evaluate all applicants based on the same criteria. Evaluating applicants based on the same criteria will ensure that only the most competitive applicants are recommended for a CCTC award.

c. Factual basis / rationale:

A clear definition of “wage or wages” is necessary for the accurate and consistent submission of information to GO-Biz by applicants. Absent a clear definition, applicants would be more likely to submit numbers based on inconsistent calculations. These inconsistencies could impact the entire field of applicants. As a result, standardized definitions are necessary. Section 8030 prescribes the application process and criteria for evaluating applications. Phase I of the evaluation process is an automated phase that yields the cost-benefit formula (benefit) to the state by calculating a ratio that divides the amount of tax credit requested by an applicant by the sum of its “aggregate employee compensation” and “aggregate investment.” “Wage or wages” are a component of “aggregate employee compensation.” A misinterpretation of these inputs could result in an artificially inflated or deflated ratio. For example, if an applicant was not clear that “aggregate employee compensation” only includes “wage or wages” (as defined) for “full-time employees” calculated on an “annual full-time equivalent” basis, it could include irregular or non-guaranteed forms of compensation. As a result, its artificially inflated ratio could move the applicant into phase II, taking the place of another applicant that submitted the requisite information differently. Furthermore, the applicant, if awarded a credit, could have challenges complying with the terms of the agreement and claiming a credit if forms of variable compensation are not excluded from the definition of “wage or wages.”

d. Underlying data:

No relevant data or empirical studies were available regarding the definition of “wage or wages.”

e. Consideration of alternatives:

GO-Biz considered defining “wage or wages” to be inclusive of variable forms of compensation, this option was rejected because the range and options of bonuses, tips, stock options, and commissions vary greatly from one employer, region, or industry type to another and can greatly fluctuate from one year to the next.

• “HIGH POVERTY AREA” AND “HIGH UNEMPLOYMENT AREA” - DEFINITIONS

a. Issue being addressed:

Rev. and Tax. Code sections 17059.2 and 23689 require that GO-Biz “give priority to a taxpayer whose project or business is located or proposed to be located in an area of high unemployment or poverty.” However, the statutes do not provide definitions for these terms. Accordingly, GO-Biz decided to define such terms and incorporate them into the criteria used in phase I to move applicants into phase II (as discussed in the proposed amendments to Section 8030 later in this document).

The proposed definition of “high unemployment area” is defined as “a city and/or county with an unemployment rate of at least 150 percent of the California statewide unemployment rate

based on the most recently updated data available from the California Employee Development Department (EDD) thirty days prior to the application period.”

The proposed definition of “high poverty area” is defined as “a city and/or county with a poverty rate of at least 150 percent of the California statewide poverty rate per the most recently updated data available from the U.S. Census Bureau’s American Community Survey 1-year estimates thirty days prior to the first day of the applicable application period.”

b. Anticipated benefits from this regulatory action:

Defining “high unemployment area” and “high poverty area” will enable GO-Biz to use a quantifiable methodology for meeting the statutory requirement to give priority to projects and job creation that are proposed to take place in areas of high unemployment and/or poverty. Defining the meaning of “high poverty area” and “high unemployment area” contributes to the standardization of the evaluation process. This change demonstrates to applicants that GO-Biz will continue to look at whether the jobs being created will provide employment opportunities in the areas given priority by statute. Further, this change allows GO-Biz a method to factor in unemployment and/or poverty during the phase I analysis, as opposed to, the current practice of considering unemployment and/or poverty during phase II only.

c. Factual basis / rationale:

The processes described above are based on the requirements set forth in Rev. and Tax. Code sections 17059.2 and 23689.

d. Underlying data:

No relevant data or empirical studies were available regarding the definitions of “high unemployment area” and “high poverty area.”

e. Consideration of alternatives:

- (i) GO-Biz initially considered not defining “high unemployment area” or “high poverty area.” This option was rejected as it did not give applicants a clear understanding of the criteria that will be used as part of the application evaluation process.
- (ii) GO-Biz considered alternative definitions to “high poverty area” and “high unemployment area” that would have limited the CCTC to applicants located in specific high poverty and/or unemployment census tracts. Geographic areas with relatively low percentages of unemployed residents may draw employees from nearby areas that have high numbers of unemployed individuals who can benefit from projects that propose to create jobs within close proximity to and within commuting distance of, but not technically within, an economically distressed census tract. As such, this option was rejected as too restrictive. Further, this option would involve developing and updating a mapping tool, which would be difficult for businesses to overlay with their project locations.

**(2) Section Affected: Chapter 13, Article 1, Section 8030 (b) - Application Process for Tax Credit Allocation.**

- DIVERSE AND INCLUSIVE WORK FORCE QUESTION

- a. Issue being addressed:

Subsection (b) of section 8030 clarifies the information applicants will need to provide as part of the application process. Specifically, proposed new paragraph (58) of subsection (b) requests that applicants describe their efforts to recruit and hire a diverse and inclusive workforce. The CCTC Committee has requested this information on multiple occasions. Adding this component to the regulations will enable GO-Biz to amend the application to request this information and provide it to the CCTC Committee.

- b. Anticipated benefits from this regulatory action:

Requesting this information as part of the application process will enable GO-Biz to provide data to the CCTC Committee that it has consistently requested as part of its deliberations.

- c. Factual basis / rationale:

The amendment is responsive to requests from the CCTC Committee. Requesting this information in advance enables GO-Biz to provide a summary to the CCTC Committee and better prepares applicants to address and describe their hiring practices during CCTC Committee meetings.

- d. Underlying data:

GO-Biz did not rely on any underlying data or empirical studies for this addition.

- e. Consideration of alternatives:

GO-Biz considered not amending the regulations to request this information. This option was rejected as it could potentially harm CCTC applicants that are unprepared to answer this question when and if posed by the CCTC Committee. Requesting this information in advance enables GO-Biz to provide a summary to the CCTC Committee and better prepares applicants to address and describe their hiring practices during CCTC Committee meetings.

- HIGH UNEMPLOYMENT AND HIGH POVERTY - MOVING APPLICATIONS TO PHASE II

- a. Issue being addressed:

Paragraph (59) of subsection (b) of section 8030 requires the applicant to assert whether at least seventy-five percent of the net increase of full-time employees will work at least seventy-five percent of their time in a “high unemployment area” or a “high poverty area.” GO-Biz needs this information in order to determine if an application should automatically move into phase II.

Subparagraph B of paragraph (1) of subsection (b) of section 8030 has been added to define the process by which priority will be given to applicants whose projects will take place in areas of high unemployment or high poverty. Specifically, GO-Biz may move an applicant into phase II automatically, regardless of its “ratio,” if at least seventy-five percent of its net increase of full-time employees will work at least seventy-five percent of the time in an area of high unemployment or high poverty.

b. Anticipated benefits from this regulatory action:

The information applicants are required to submit as part of the application ensures that GO-Biz receives clear and consistent information from each applicant. This section also provides mechanisms to ensure that credits are only awarded to the applicants that meet the statutory evaluation criteria, have the highest need, and have the highest likelihood of project success.

c. Factual basis / rationale:

The processes described above are based on the requirements set forth in Rev. and Tax. Code sections 17059.2 and 23689.

d. Underlying data:

GO-Biz did not rely on any underlying data or studies for this addition.

e. Consideration of alternatives:

GO-Biz considered continuing its current practice of evaluating high poverty and high unemployment as part of the phase II evaluation. This option was rejected because GO-Biz found that businesses in areas of high poverty and high unemployment frequently have less competitive ratios than businesses that operate outside of these areas. As a result, these applicants do not frequently advance to Phase II where the levels of high poverty and high unemployment could be taken into account.

**(3) Section Affected: Chapter 13, Article 1, Section 8030 (g)(1) - Evaluation Process for Tax Credit Allocation.**

- HIGH UNEMPLOYMENT AND HIGH POVERTY AREA - QUESTION

a. Issue being addressed:

This amendment moves existing language from subsection (g) paragraph (1) to new subparagraph (g)(1)(A), and creates new a subparagraph (B). Existing subsection (g) of section 8030 specifies the criteria by which GO-Biz may move an applicant from phase I to phase II of the application process. The existing paragraph (1) of subsection (g) of section 8030 clarifies that phase I is a quantitative process where only the most competitive ratios move forward to phase II. The ratio compares two factors, aggregate employee compensation and aggregate

investment, to the amount of tax credit requested. The most competitive ratios are moved to phase II.

Subparagraph (B) is added to allow applicants to move automatically into phase II if they assert that at least seventy-five percent of the net increase of full-time employees will work at least seventy-five percent of the time in an area of high unemployment or high poverty.

Automatically moving applicants in high unemployment or high poverty areas into phase II enables GO-Biz to enter into discussions and request information from these businesses that it would otherwise might not have the opportunity to request.

b. Anticipated benefits from this regulatory action:

The information applicants are required to submit as part of the application ensures that GO-Biz receives clear and consistent information from each applicant. This section also provides mechanisms to ensure that credits are only awarded to the applicants that meet the statutory evaluation criteria, have the highest need, and have the highest likelihood of project success.

c. Factual basis / rationale:

The processes described above are based on the requirements set forth in Rev. and Tax. Code sections 17059.2 and 23689.

d. Underlying data:

GO-Biz did not rely on any underlying data or studies for this portion of the proposed amendment.

e. Consideration of alternatives:

GO-Biz considered continuing its current practice of reviewing high poverty and high unemployment as part of the phase II evaluation. This option was rejected because GO-Biz found that businesses in areas of high poverty and high unemployment frequently have less competitive ratios than businesses that operate outside of these areas. As a result, these applicants do not frequently advance to phase II where the levels of high poverty and high unemployment could be taken into account.

• CONSULTING FEE ARRANGEMENT

a. Issue being addressed:

Subparagraph (H) of paragraph (2) of subsection (g) is being amended to remove the requirement instructing applicants that any contingency fee arrangement must result in a fee that is less than or equal to the product of the number of hours of service provided to the applicant and a reasonable hourly rate for such services.

b. Anticipated benefits from this regulatory action:

The changes proposed to this section will clarify the process by which GO-Biz will review the reasonableness of the fee arrangement between the applicant and the consultant.

c. Factual basis / rationale:

Rev. and Tax. Code sections 17059.2 and 23689 were recently amended by Senate Bill 836, Statutes 2016, Chapter 31, sections 273 and 275, to clarify existing GO-Biz authority to consider the reasonableness of fee arrangements to ensure the effective use of tax credits is maximized.

d. Underlying data:

GO-Biz did not rely on any underlying data or empirical studies for this portion of the proposed amendment.

e. Consideration of alternatives:

GO-Biz did not consider any alternatives.

**C. Anticipated Overarching Benefits of the Entire Proposed Regulatory Amendments:**

This regulatory amendment package standardizes definitions and ensures accuracy in CCTC applications. Further, it makes clear the information business applicants will need to gather and submit as part of the application and evaluation processes.

**D. Reasonable Alternatives to the Regulation and GO-Biz's Reasons for Rejecting Those Alternatives**

Reasonable alternatives for each of the proposed amendments are addressed throughout this ISOR.

**E. Reasonable Alternatives to the Proposed Regulatory Action that Would Lessen any Adverse Impacts on Small Businesses**

GO-Biz has not identified any adverse impact on small businesses as a result of these regulation changes. To the contrary, these proposed regulations, as noted, provide clarity on the nature and type of information required, and as such, will aid small businesses in the CCTC application process.

**F. Evidence Supporting a Finding of no Significant Statewide Adverse Economic Impact Directly Affecting Business**

GO-Biz has determined that there is no evidence of adverse economic impact to businesses as a result of these amendments. The proposed amendments to the regulations are minor in nature and will not have any discernible economic impact.

**G. Economic Impact Assessment/Analysis**

#### Creation or Elimination of Jobs within the State of California

The amendments are designed to provide clarity to businesses on the definitions and application process. The amendments do not substantively alter the application or program implementation processes. These amendments do not add or remove any additional activities or responsibilities for state staff. Therefore, no jobs in California will be created or eliminated.

#### Creation of New or Elimination of Existing Businesses Within the State of California

The amendments are designed to provide clarity to businesses on the definitions and application process. The amendments do not substantively alter the application or program implementation processes. Therefore, no new businesses in California will be created or existing businesses eliminated as a result of these amendments.

#### Expansion of Businesses or Elimination of Existing Businesses Within the State of California

The amendments are designed to provide clarity to businesses on the definitions and application process. The amendments do not substantively alter the application or program implementation processes. Therefore, no existing businesses in California will be created or existing businesses eliminated as a result of these amendments.

#### Benefits of the Regulations on Worker Safety and the State's Environment

The amendments are designed to provide clarity to businesses on the definitions and application process. The amendments do not substantively alter the application or program implementation processes. Further, they make clear the information business applicants will need to gather and submit as part of the application and evaluation processes. These amendments do not benefit or otherwise impact worker safety and the state's environment.