California Tax Rates – Highest or Lowest in the Country?
It Depends on Your Address

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California is a great state with a vibrant economy, but we are consistently ranked near the bottom of national surveys evaluating the business-friendly nature of states throughout the country. While workforce, quality education systems, state and local regulations, and general operating costs are factored into these rankings, a state's tax policies weigh heavily on these surveys – as well on the minds of business owners.

Earlier this month Supply Side Economists, Arthur Laffer and Stephen Moore, released their latest comparative study of state competitiveness. This study, sponsored by the American Legislative Council, concludes that California is in the bottom 10 competitive states, based on 16 economic variables, including tax rates, state regulations, labor policies, etc. According to Laffer, in the last decade California has had only 50% of the population and job growth as compared to the 10 most favorably ranked states.

California residents have also experienced income growth rates one-third slower than the top 10 states – which include: Utah, Arizona, South Dakota, Wyoming and Tennessee.

It is clear that California businesses and individuals are faced with some of the highest marginal tax rates in the country – at 8.82% for most C Corporations and up to 10.3% for individuals making more than $1 million (note: an S Corporation owner can experience combined marginal rates of up to 11.8% for California purposes, when adding in the 1.5% California S Corporation level "toll tax").

However, there is a silver lining for California businesses and their equity owners (as well as certain lenders). Businesses can dramatically reduce their California income/franchise taxes by choosing to operate in any one of the 42 Enterprise Zones (EZ) jurisdictions throughout the state. The California and federal programs (e.g. Empowerment Zone, Renewal Communities, Indian Tribal Lands, etc.) can make California a very attractive place to start a business of any size.

The California EZ program was developed in the mid 1980's to encourage businesses to locate in, and expand in, economically depressed areas. Since these EZ's have a higher concentration of businesses within their boundaries, approximately 20 % of California businesses are eligible for current year savings and possibly refunds for prior years, yet only a small fraction of these companies claim all the benefits they are entitled to. The program was extended and expanded during the last legislative session and is generally available for up to 15 years.

By establishing or expanding a business in one or more of California's EZ's, businesses (as well as equity owners of S Corporations, LLC's and Partnerships) are eligible for the following tax benefits:

1. Up to $11,700 of annual hiring tax credits for each economically disadvantaged or "at-risk" employee working in the EZ. Qualifying employees include residents living in certain census tracts (Targeted Employment Areas), most veterans, previously unemployed or downsized, physically or mentally challenged, Native Americans, and a variety of other employees,

2. A sales/use tax credit for manufacturing (up to 9.25%), processing, technology, pollution control or energy conservation equipment used solely within an EZ,
3. Favorable financing, grants and/or preferential bidding on government contracts, and
4. Employee-level credits of up to $525 available to any employee working in an EZ with Adjusted Gross Income less than $16,334 (single) or $32,667 (joint).

For businesses making these socially responsible investments in EZ's, the combined benefits can often reduce a taxpayer's California tax liability to a small fraction of what taxpayers operating outside the EZ will pay. The net impact to the business includes lower labor/equipment costs, improved cash flow, additional funding to expand workforce and improve infrastructure, and higher business valuations.

In coming years, we will likely see more companies and investors integrating these Location Based Incentive Credits (LBIC) into their strategic plans. The reason these programs resonate with businesses is that they produce a win-win-win result for employers-employees-communities:

- **Employers** – obtain tax savings and easier funding; employees work for more financially secure companies with resources for training, technology and infrastructure.
- **Employees –** can also obtain valuable personal-level tax credits.
- **Community** – benefits via lower unemployment rates, modernized business districts, and improved business and residential real estate values.

CalPERS, CALSTRS and private equity firms are beginning to take a hard look at making strategic investments in Emerging Domestic Markets (EDM), which overlap with the vast majority of EZ's. These business communities are often populated with entrepreneurial start-ups involved in research & development, manufacturing/ processing, and distribution other B2B businesses.

There are already significant LBIC tax breaks (often not quantified) sitting in many private equity firm's portfolio companies, and these types of tax-advantaged investments will increase in coming years.

In addition to the state EZ program, there are 40 other states with impactful LBIC programs. Some states with attractive inventive programs include: New York, Florida, Illinois, Georgia, Arkansas, Arizona and the Carolinas.

There are also thousands of federal LBIC programs available in the majority of states with a variety of LBIC's, including: Empowerment Zones, Renewal Communities, Gulf Opportunity Zones and Indian Tribal Lands programs. These federal programs generate employer hiring credits ranging from $1,500 to $4,800 per year, for each "qualified" employee and are available in over 5,000 distinct regions throughout the U. S.

Earlier this year, Congress dramatically expanded the federal Work Opportunity Tax Credit (WOTC) program ($2,400 to $4,800 per "qualified employee") to include a new category of eligible employee who is between the ages of 18 and 40 and lives in any one of the 408 newly designated "Rural Renewal Counties" representing approximately 13% of the U.S. Unlike most other LBIC programs, the WOTC (and Welfare-to-Work) program requires "certification" of the employees within 28 days of hire, but the credits are available to businesses operating in any geographic location.

In addition to these valuable credits, certain state programs, as well as the Federal Empowerment and Renewal Community programs contain gain exclusions and/or other benefits upon the sale of certain business assets. For example, the seller of certain capital gain assets in a Federal Empowerment Zone can exclude up to 50% of such gain or roll over the gain into another Empowerment Zone business. Certain assets held over five years in a Renewal Community can be sold with a 100% federal exclusion.

So the next time you hear a business owner bashing the state or federal tax system, just tell them that effective tax planning can start with these three simple words: “Location, Location, Location”.

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