ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author:	Allen	Analyst:	Brian Werking	Bill Number:	AB 1196
Related Bills:	See Legislative History	Telephone:	845-5103	Amended Date:	March 31, 2011
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Earned Income Refundable Credit

SUMMARY

This bill would allow a refundable earned income credit (EIC) equal to 15 percent of the federal EIC.

RECOMMENDATION AND SUPPORTING ARGUMENTS

No position.

Summary of Amendments

The March 31, 2011, amendments removed legislative intent language and replaced it with the provisions discussed in this analysis. This is the department's first analysis of the bill.

Summary of Suggested Amendments

Amendments in the Technical Considerations discussion below have been provided to remedy technical, non-substantive language concerns.

PURPOSE OF THE BILL

It appears the purpose of this bill is to encourage employment and provide tax relief and financial support to low-income taxpayers.

EFFECTIVE/OPERATIVE DATE

This bill would be effective on January 1, 2012, and specifically operative for taxable years beginning on or after January 1, 2012.

ANALYSIS

FEDERAL/STATE LAW

Existing federal law allows eligible individuals a refundable EIC. A refundable credit allows for the excess of the credit over the taxpayer's tax liability to be refunded to the taxpayer. The credit is a percentage of the taxpayer's earned income and is phased out as income increases. The percentage varies, based on whether the taxpayer has qualifying children.

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The federal credit for the 2010 taxable year is determined as follows:

An eligible individual With:	Earned Income	Completely Phased-Out @	Credit Rate (%)	Maximum Credit (for all file statuses)
1 qualifying child	$8,970	$35,535 ($40,545 if married filing jointly	34.00%	$3,050
2 or more qualifying children	$12,590	$40,363 ($45,873 if married filing jointly)	40.00%	$5,036
3 or more qualifying children	$14,165	$43,352 ($48,362 if married filing jointly)	45.00%	$5,666
No qualifying children	$5,973	$13,460 ($18,470 if married filing jointly	7.65%	$457

Married individuals are eligible for only one credit on their combined earned income and must file a joint return to claim the credit.

Existing federal law specifies that if the federal EIC was denied and the Internal Revenue Service (IRS) determined that the taxpayer's error was due to reckless or intentional disregard of EIC rules, the EIC will not be allowed for the next two years. If the error was due to fraud, the EIC will be denied for the next ten years.

Under provisions of federal law (Title IV of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996 (P.L. 104-193)), certain individuals not lawfully admitted for permanent residence in the United States are ineligible for federal, state, and local public benefits, including the EIC. IRS implementation of Title IV is limited to verifying eligibility on the basis of social security numbers. The IRS delays all returns claiming the federal EIC that do not pass an automated social security number verification process. By its terms, this federal law applies to states that allow the EIC.

California does not provide an EIC. Existing state laws provide various tax credits designed to provide tax relief for taxpayers that incur certain expenses (e.g., child and dependent care credits), to influence business practices and decisions or to achieve social goals. Credits are allowed against net tax based on a set order of priority as specified in the Revenue and Taxation Code.

Under state law, individuals with income below the filing thresholds are not required to file an income tax return because the standard deduction and personal exemption credit eliminate any tax liability. For 2010, these thresholds are $14,754 in gross income or $11,803 in adjusted gross income (AGI) for single taxpayers and $29,508 in gross income or $23,607 in AGI for married filing joint taxpayers. These thresholds are increased based on the number of dependents claimed and are increased annually for inflation.

THIS BILL

This bill would provide a refundable state EIC equal to 15 percent of the version of the federal EIC (prior to its reduction by alternative minimum tax (AMT)) in effect as of January 1, 2011. The amount of state EIC would be reduced by state AMT, if applicable. Any state credit in excess of the state tax liability would be credited against other amounts due, and the balance would be refunded to the taxpayer. The refunded portion of the state EIC would be provided for through continuous appropriations from the General Fund.

This bill specifies that no credit shall be allowed to (1) any person who is treated as a nonresident for any portion of the taxable year, or (2) any person who is married and files a separate return for the taxable year.

IMPLEMENTATION CONSIDERATIONS

Many taxpayers eligible for the federal EIC have no California income tax return filing requirement. These nonfilers would be required to file a California income tax return to claim the proposed state EIC, which could impact the department's programs and costs.

Typically, refund returns are filed early in the filing season. If taxpayers claiming the California EIC file late in the filing season, after they receive their federal EIC, that behavior could have a major impact on the processing of returns and possibly cause delays in the issuance of refunds. The taxpayer error rate on the federal EIC and the fraud concerns cause the IRS to adjust many returns. Consequently, the correct federal EIC amount may be unknown until after the taxpayer has filed the state return, claimed the proposed California credit, and received a refund. The Franchise Tax Board (FTB) could be required to issue an assessment to retrieve incorrect refunds and incur costs to do so.

Relying on the EIC under federal law may present implementation problems for Registered Domestic Partners (RDPs). RDPs are required to file California income tax returns using the rules applicable to married individuals. If the author's intent is to allow EIC for RDPs, a rule should be included in the bill to address the difference between federal and state law.

Historically, the department has had significant problems with refundable credits and fraud. These problems are aggravated because if a refund is made that is later determined to be fraudulent, the refund commonly cannot be recovered. Striking the refundability provision from this credit would substantially reduce the department's concerns regarding fraud.

TECHNICAL CONSIDERATIONS

On page 2, line 18, delete "treated as".

On page 2, line 29, replace "subdivisions" with "subdivision".

LEGISLATIVE HISTORY

AB 21 (Jones, 2007/2008), similar to this bill, would have established a nonrefundable EIC equal to 5 percent of the federal EIC. AB 21 failed to pass out of the Assembly Appropriations Committee.

SB 224 (Cedillo, 2003/2004), similar to this bill, would have provided a refundable EIC equal to 15 percent of the federal EIC. SB 224 failed to pass out of the Senate Revenue & Taxation Committee.

AB 106 (Cedillo, 2002/2001), similar to this bill, would have provided a refundable EIC equal to 15 percent of the federal EIC. AB 106 failed to pass out of the Assembly Appropriations Committee.

AB 1854 (Cedillo, 1999/2000), similar to this bill, would have provided a refundable EIC equal to 15 percent of the federal EIC. AB 1854 failed to pass out of the Assembly Appropriations Committee.

AB 2466 (Wiggins, 1999/2000) would have provided a nonrefundable EIC in an amount equal to an unspecified percentage of the earned income credit allowed by federal law. This bill failed to pass out of the Assembly Revenue & Taxation Committee.

SB 1421 (Solis, 1999/2000), similar to this bill, would have provided a refundable EIC equal to 15 percent of the federal EIC. SB 1421 failed to pass out of the Senate Revenue & Taxation Committee.

OTHER STATES' INFORMATION

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York.* These states were selected due to their similarities to California's economy, business entity types, and tax laws.

Florida does not provide any tax credit comparable to the credit proposed by this bill.

Illinois allows taxpayers to claim a refundable credit equal to 5 percent of their federal EIC on their return.

Massachusetts allows taxpayers to claim a refundable credit equal to 15 percent of their federal EIC.

Michigan allows taxpayers to claim a refundable credit equal to 20 percent of their federal EIC.

Minnesota allows taxpayers to claim a Working Family Credit (WFC) if they also claimed the federal EIC. The WFC is based on either the federal earned income or the federal AGI depending on whichever amount is smaller.

New York allows taxpayers to claim a refundable credit equal to 30 percent of the federal EIC on their return for tax years beginning in 2003.

FISCAL IMPACT

This bill would require instructions and a calculation for the credit that would require a new form or worksheet to be developed. As a result, this bill would impact the department's printing, processing, and storage costs for tax returns. The additional costs will be developed as the bill moves through the legislative process. It is recommended that the bill be amended to include appropriation language that would provide funding to implement this bill. Lack of an appropriation will require the department to secure the funding through the normal budgetary process, which will delay implementation of this bill.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue losses:

Estimated Revenue Impact of AB 1196 For Taxable Years Beginning On or After January 1, 2012 Enactment Assumed After June 30, 2011 ($ in Millions)		
2011-12	2012-13	2013-14
-$420	-$750	-$750

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

LEGAL IMPACT

This bill contains provisions that would target certain incentives to residents of California while denying the same incentives to nonresidents. The U.S. Supreme Court in *Lunding Et Ux. v. New York Appeals Tribunal et al.* (1998) 118 S. Ct. 766, found that denying a tax benefit to a nonresident taxpayer, while allowing such a benefit to resident taxpayers, was discriminatory and thus unconstitutional. Consequently, an EIC conditioned on full-year residency in California may be subject to constitutional challenge.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Pro: Some taxpayers may say that in a time in which many low-income outreach programs are being cut it is important to provide financial assistance to these affected groups, as this bill would accomplish.

Con: Some taxpayers may say that with the state's current fiscal crisis, additional tax expenditures should be avoided.

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