ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author:	Dickinson	Analyst:	Brian Werking	Bill Number:	AB 1974
Related Bills:	See Legislative History	Telephone:	845-5103	Introduced Date:	February 23, 2012
		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.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to increase the incomes of the working poor, thereby aiding families and children to rise above the poverty line.

EFFECTIVE/OPERATIVE DATE

This bill would be effective on January 1, 2013, and would be specifically operative for taxable years beginning on or after January 1, 2013.

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 2011 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	$9,100	$36,052 ($41,132 if married filing jointly)	34.00%	$3,094
2 or more qualifying children	$12,780	$40,964 ($46,044 if married filing jointly)	40.00%	$5,112
3 or more qualifying children	$12,780	$43,998 ($49,078 if married filing jointly)	45.00%	$5,751
No qualifying children	$6,065	$13,660 ($18,740 if married filing jointly)	7.65%	$464

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. In general, for taxable year 2011, these thresholds are $15,152 in gross income or $12,122 in adjusted gross income (AGI) for single taxpayers and $30,305 in gross income or $24,244 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[1] (AMT)) in effect as of January 1, 2012. 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. Any refund would be excluded from taxable income. The refunded portion of the state EIC would be provided from the continuously appropriated Tax Relief and Refund Account.

This bill specifies that no credit shall be allowed to (1) any person who is 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

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve these and other concerns that may be identified.

Many personal income 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 when 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.

[1] The alternative minimum tax liability ensures that taxpayers with substantial economic income and credits, deductions, and other preference items do not completely escape taxation.

LEGISLATIVE HISTORY

AB 1196 (Allen, 2011/2012), similar to this bill, would have established a nonrefundable EIC equal to 15 percent of the federal EIC. AB 1196 failed to pass out of the Assembly Appropriations Committee by the constitutional deadline.

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 by the constitutional deadline.

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 by the constitutional deadline.

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 by the constitutional deadline.

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 only has a corporation income tax therefore this personal income tax credit is not applicable.

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

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

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

Minnesota allows personal income taxpayers to claim a refundable 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.

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 would require the department to secure the funding through the normal budgetary process, which would delay implementation of this bill.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue losses:

Estimated Revenue Impact of AB 1974 For Taxable Years Beginning On Or After January 1, 2013 Enactment Assumed After June 30, 2012 ($ in Millions)		
2013-14	2014-15	2015-16
-$180	-$900	-$900

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 proponents 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 opponents may say that with the state's current fiscal crisis, additional tax expenditures should be avoided.

LEGISLATIVE STAFF CONTACT

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