Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Dickinson	Analyst:	Brian Werking	Bill Number:	AB 1974
Related Bills:	See Legislative History	Telephone:	845-5103	Amended Date:	March 26, 2012
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Earned Income Tax Credit

SUMMARY

The bill would create an earned income tax credit (EITC) in an amount equal to 15 percent of the federal EITC.

RECOMMENDATION

No position.

Summary of Amendments

The March 26, 2012, amendments specify that the EITC would only be refundable for taxable years in which the Legislature makes an appropriation; when no appropriation is made, the credit could be carried over to succeeding taxable years until the credit would be exhausted. The amendments would also require the Franchise Tax Board (FTB) to establish a waitlist for refunds for taxable years in which an appropriation was made, but the aggregate amount of refunds exceeds the amount available in the Tax Relief and Refund Account. The amendments eliminate the provisions that would have allowed the EITC to be reduced by the amount of alternative minimum tax. The amendments also provide that the credit would apply for taxable years beginning on or after January 1, 2012, rather than January 1, 2013.

As a result of the amendments, the department's analysis of the bill as introduced February 23, 2012, no longer applies.

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

As a tax levy, this bill would be effective immediately upon enactment and operative for taxable years beginning on or after January 1, 2012.

Board Position:			Executive Officer	Date
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ANALYSIS

FEDERAL/STATE LAW

Existing federal law allows eligible individuals a refundable EITC. 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.

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

California does not provide an EITC. 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 state EITC equal to 15 percent of the federal EITC as in effect on January 1, 2012. 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, if an appropriation was made by the Legislature. Any refund would be excluded from taxable income and would not be considered income for purposes of determining amounts or eligibility for other benefits[1]. The refunded portion of the state EITC would be provided for by an appropriation from the Legislature to the Tax Relief and Refund Account.

The bill would provide that when the appropriation is insufficient to cover the total amount of the EITC refunds due taxpayers for any taxable year, the FTB would establish and maintain a list of taxpayers that are owed a refund. The FTB would establish an order of priority within the waitlist, based on the date the FTB receives a taxpayer's return. The FTB would also be required to notify each taxpayer that has been placed on the waitlist.

The bill would provide that in any year for which no appropriation has been made by the Legislature, the EITC could be carried over to succeeding taxable years until the amount of the credit is exhausted.

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.

The bill would allow the EITC to be refunded if there is an appropriation. The bill fails to specify how the credit would be treated where an appropriation is provided after a taxpayer has filed to carry the credit over. It is unclear, if a taxpayer could amend their return to claim a refund. The bill should be amended to address this issue.

[1] Benefits provided under Division 9 (commencing with Section 10000) of the Welfare and Institutions Code.

The bill fails to specify how the portion of the credit that is not refunded to a taxpayer because of an inadequate appropriation is to be treated in future taxable years. If after an inadequate appropriation is made, and there are no future appropriations ever made to refund the refundable amount of the credit to those taxpayers on the waiting list, a taxpayer may be prevented from using the refundable portion of the credit to offset tax. To prevent this outcome, it is recommended that the bill be amended to specify how the portion of the credit not refunded to a taxpayer because of an inadequate appropriation should be treated.

Relying on the EITC 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 EITC for RDPs, a rule should be included in the bill to address the difference between federal and state law.

Many personal income taxpayers eligible for the federal EITC 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 EITC file late in the filing season, after they receive their federal EITC, 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 and fraudulently claimed federal EITC cause the IRS to adjust many returns. Consequently, the correct federal EITC amount may be unknown until after the taxpayer has filed the state return, claimed the proposed California credit, and received a refund. The FTB could be required to issue an assessment to retrieve incorrect refunds and incur costs to do so.

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.

Because the bill fails to specify otherwise, the FTB would be subject to the rulemaking procedures required under the Administrative Procedures Act (APA)[2]. Following these procedures may delay the immediate implementation of this bill. To prevent any delay, it is recommended that the author add a provision exempting the FTB from the APA when the FTB is prescribing rules, guideline, or procedures necessary or appropriate to carry out the purpose of this bill.

This bill would require the FTB create a waitlist with an order of priority based on the date a taxpayer's return is received. If this date is disputed by a taxpayer and the dispute is then reviewed in a judicial or administrative hearing, it could significantly delay the FTB in sending out refunds to taxpayers on the waitlist. To prevent any delay, it is recommended that the author add a provision providing that for the purposes of the waitlist, the date a return is received shall be determined by the FTB and that determination may not be reviewed in any judicial or administrative proceeding.

[2] Government Code section 11340 et seq.

LEGISLATIVE HISTORY

AB 1196 (Allen, 2011/2012) similar to this bill, would have established a nonrefundable EITC equal to 15 percent of the federal EITC. 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 EITC equal to 5 percent of the federal EITC. 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 EITC equal to 15 percent of the federal EITC. SB 224 failed to pass out of the Senate Revenue & Taxation Committee by the constitutional deadline.

AB 106 (Cedillo, 2001/2002) similar to this bill, would have provided a refundable EITC equal to 15 percent of the federal EITC. 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 EITC on their return.

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

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

Minnesota allows personal income taxpayers to claim a refundable Working Family Credit (WFC) if they also claimed the federal EITC. 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 EITC.

FISCAL IMPACT

This bill would require instructions and a calculation for the credit that would require a new form or worksheet to be developed. The bill would also require the FTB to establish and maintain a waitlist of taxpayers, notify taxpayers of an appropriation, and notify taxpayers if they have been placed on the waitlist. As a result, this bill would impact the department's programming, printing, processing, mailing, and storage costs for tax returns. The additional costs have not been determined at this time. As the bill continues to move through the legislative process, costs will be identified, and an appropriation will be requested, if necessary.

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, 2012 Enactment Assumed After June 30, 2012 ($ in Millions)			
	2012-13	2013-14	2014-15
Assuming No Appropriation	-$110	-$100	-$110
Assuming An Appropriation Is Made	-$1,000	-$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[3]

Support: None provided.

Opposition: None provided.

[3] As reported on the Legislative Counsel's Web site: http://www.leginfo.ca.gov/cgi-bin/postquery [as of April 5, 2012]

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.

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

POLICY CONCERNS

This bill fails to limit the number of years for the carryover period. The department would be required to retain the carryover on the tax forms indefinitely because an unlimited credit carryover period is allowed. Recent credits have been enacted with a carryover period limitation since experience shows credits typically are exhausted within eight years of being earned.

LEGISLATIVE STAFF CONTACT

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