Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Vidak	Analyst:	Davi Milam	Bill Number:	SB 152
Related Bills:	See Legislative History	Telephone:	845-2551	Amended Dates:	March 16, 2015
		Attorney:	Bruce Langston	Sponsor	

SUBJECT:	Refundable Earned Income Tax Credit (EITC)

SUMMARY

This bill, under the Personal Income Tax Law (PITL), would create a refundable California earned income tax credit (EITC).

This analysis only addresses the provisions of the bill that impact the department's programs and operations.

RECOMMENDATION

No position.

Summary of Amendments

The March 16, 2015, amendments changed the author and removed the bill's prior language that made a technical change and replaced it with a refundable state EITC. This is the department's first analysis of the bill.

Summary of Suggested Amendments

Amendments have been suggested to resolve technical concerns.

REASON FOR THE BILL

The reason for the bill is to reduce poverty among low- to middle-income working families and to provide an economic stimulus.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment and specifically operative for taxable years beginning on or after January 1, 2016, and before January 1, 2023.

FEDERAL/STATE LAW

Federal 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.

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The federal credit rate for the 2014 taxable year varies from 7.65 percent to 45 percent, depending on filing status and the number of qualifying children. The 2014 Adjusted Gross Income (AGI) amount at which the EITC is completely phased out is:

An eligible individual with :	Completely Phased-Out at[1]:	2014 Max. Credit
No qualifying children	$14,590 ($20,020 if married filing jointly)	$496
1 qualifying child	$38,511 ($43,941 if married filing jointly)	$ 3,305
2 qualifying children	$43,756 ($49,186 if married filing jointly)	$ 5,460
3 or more qualifying children[2]	$46,997 ($52,427 if married filing jointly)	$ 6,143

The maximum investment income a taxpayer can have and still get the credit is $3,350 in 2014.

An eligible individual[3] must have a social security number (SSN)[4], and generally must meet AGI and investment income requirements as well as filing requirements if claiming an increased credit amount for having a qualifying child (children).

A qualifying child[5] must have an SSN and meet a number of requirements. Generally, a qualifying child must live with the eligible individual for more than one-half of the taxable year, and be under the age of 19, unless the child is a full-time student or is permanently and totally disabled. Only one person can claim a qualifying child.

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 EITC would be denied for the next two years. If the error was due to fraud, the denial period would be ten years.

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[1] Internal Revenue Code (IRC) section 32(j) provides that the phase out amounts and the maximum amount of investment income shall be adjusted for inflation each year.
[2] IRC section 32(b)(3) provides special rules for taxable years beginning on or after 2008 and before 2018 for taxpayers with 3 or more qualifying children, including an increased credit percentage and an inflation adjustment related to the reduction of the marriage penalty.
[3] IRC section 32(c)(1).
[4] IRC section 32(m) provides that for purposes of the EITC a taxpayer identification number (TIN) means a social security number.
[5] IRC section 32(c)(3) requires the "qualifying child" to be a dependent of the taxpayer by reference to IRC section152(c). The name, age, and SSN of the qualifying child must be shown on the tax return.

Existing federal law requires paid preparers who prepare tax returns claiming the federal EITC to perform certain due diligence requirements. A penalty is imposed for failure to satisfy the due diligence requirements.[6]

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 EITC that do not pass an automated social security number verification process. By its terms, this federal law applies to states that allow an EITC.

State Law

California does not provide an EITC.[7] 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 (R&TC). Existing state law provides general provisions regarding the calculation of credits for part year and non-residents.

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 2014, these filing thresholds are $16,047 in gross income or $12,838 in AGI for single taxpayers and $33,097 in gross income or $25,678 in AGI for married filing joint taxpayers. These filing thresholds are increased based on the number of dependents claimed and are adjusted annually for inflation.

Under state law, individuals with a filing requirement generally must file a personal income tax return by the original due date (generally on or before April 15th following the close of the calendar year), or the extended due date. California allows a six-month automatic paperless extension of time to file returns without the need for specific written requests by taxpayers. The extension of time for filing applies only to the due date of the return and does not extend the time for any payment of tax. Tax is due on the original due date of the return, without regard to any filing extension. If the tax is not paid by the due date of the return, a late payment penalty is imposed.

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[6] Treas. Reg. 1.6695–2 Tax return preparer due diligence requirements for determining earned income credit eligibility.
[7] However, *The Earned Income Tax Credit Information Act* (Revenue and Taxation Code (R&TC) sections 19850 through 19854) requires California employers, state departments, and certain agencies to provide formal notification of possible eligibility for the federal EITC.

Existing state law provides the Franchise Tax Board (FTB) broad authority to administer and enforce the state income tax laws[8], including, but not limited to the following:

- Issue rules and regulations necessary for enforcement.[9]
- Examine records, ascertain the correctness of any return, and determine or collect liability.[10]
- Adjust refundable credits as math error adjustments[11], not refund claim denials, and require taxpayers to file a separate new refund claim if they disagree with the adjustment.
- Electronically receive wage withholding information from the Employment Development Department (EDD).
- Receive information concerning state licensees from the State Bar, any licensing board, the Department of Real Estate, or the Insurance Commissioner.

THIS BILL

For each taxable year beginning on or after January 1, 2016, and before January 1, 2023, this bill would allow to a qualified taxpayer a refundable state EITC equal to 15 percent of the federal earned income credit amount.

This bill would define “federal earned income credit amount” to mean the amount determined under Section 32 of the IRC as amended by several public laws[12], except as provided.

This bill would define a “qualified taxpayer” to mean an individual who:

- is eligible for a credit, for federal income tax purposes, under IRC section 32, as amended through 2013, for the taxable year in which the credit allowed under this bill is claimed;
- is legally working in the state; and
- possesses a valid SSN, legal work authorization, or taxpayer’s identification number (TIN).

This bill would provide the following:

- Any credit in excess of “net tax” could be carried over to succeeding taxable years until exhausted.
- Any allowable credit in excess of state tax liability would be credited against other amounts due, if any, and the balance, upon appropriation by the Legislature, would be refunded from the General Fund to the qualified taxpayer.

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[8] R&TC section 19501 provides FTB authority to administer and enforce the laws under Part 10 (commencing with section 17000), Part 10.7 (commencing with section 21001), and Part 11 (commencing with section 23001).
[9] R&TC section 19503.
[10] R&TC section 19504.
[11] R&TC section 19052.
[12] Public Laws 111-5, 111-226, 111-312, and 112-240.

- Any amounts refunded to a qualified taxpayer would not be included in income.
- The credit allowed may be claimed only on a qualified taxpayer's timely filed original return. The FTB's determination with respect to the date a return has been received could not be reviewed in any administrative or judicial proceeding.
- Any simple error would be treated as a mathematical error appearing on the return.
- R&TC section 41 would not apply to this bill.[13]

This bill would require the FTB, for each taxable year beginning on or after January 1, 2017, and before January 1, 2023, to adjust the amounts provided in section 32(b) of the IRC[14], relating to amounts, and section 32(i) of the IRC[15], relating to denial of credit for individuals having excessive investment income for inflation. The inflation adjustment would be based on the percentage change in the California Consumer Price Index (CCPI) for all items, on a calendar year June-to June basis, as provided to the FTB by the Department of Industrial Relations.

This bill would require the FTB to do all of the following:

- Administer enforcement activities to address improper payments;
- Collaborate with the EDD to develop criteria for, and a process to verify, taxpayer income information using wage and withholding data;
- Establish criteria for, and a process to identify, high-risk returns that may be subject to increased verification procedures and suspension of payments until the information is verified; and
- Submit a report to the Legislature beginning January 1, 2017, and each January 1 thereafter, until January 1, 2023, that includes information on the eligibility for the credit, use of the credit, and information regarding improper payments. The report would be required to be submitted in compliance with Government Code section 9795.[16]

This bill would allow the FTB to prescribe rules, guidelines, or procedures as necessary or appropriate to carry out the purposes of this bill, and would exempt the FTB from the Administrative Procedure Act for purposes of administering this section.

This bill would remain in effect only until December 1, 2013, and as of that date would be repealed.

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[13] R&TC section 41 requires a bill introduced to authorize a new tax credit to include specific goals, purposes, objectives, and performance measures.
[14] IRC 32(b) (1) provides the EITC credit percentages and section 32(b)(2) provides the earned income and phase out amounts.
[15] IRC 32(i) provides the EITC excessive investment income amount.
[16] Generally, reports to the Legislature must be submitted as a printed copy to the Secretary of the Senate, as an electronic copy to the Chief Clerk of the Assembly, and as an electronic or printed copy to the Legislative Counsel.

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.

FTB's Enterprise Data to Revenue (EDR) tax system modernization project will be operational and tested by process year 2017. EDR and other information systems would require new functionality to process returns with refundable tax credits. The earliest FTB could implement a refundable credit of this magnitude without causing risk to the EDR project would be after process year 2017.[17]

Many 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 EITC, which could impact the department's programs and costs.

The taxpayer error rate on the federal EITC causes the IRS[18] 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 refundable California credit, and received a refund. The department could be required to issue an assessment to retrieve incorrect refunds and incur costs to do so.

The IRS has historically experienced a high rate of improper payments related to taxpayers claiming the federal EITC based on self-employment income. To the extent the IRS has had difficulty verifying self-employment income; this issue would be duplicated for the state EITC.

Registered Domestic Partners (RDPs) are treated as married persons under California tax law, and file California income tax returns using the rules applicable to married individuals. Federal tax law treats RDPs as unmarried individuals. It is recommended that the author amend the bill to address the difference between federal and state law.

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[17]Personal income returns are generally due on or before April 15th following the close of the calendar year, or by the extended due date, six months later. Returns filed for the 2016 tax year will generally be processed by the department during calendar year 2017.

[18] Treasury Inspector General (TIG)Report *Existing Compliance Processes Will Not Reduce the Billions of Dollars in Improper Earned Income Tax Credit and Additional Child Tax Credit Payments*, dated September 29, 2014. Reference Number 2014-40-093. http://www.treasury.gov/tigta/auditreports/2014reports/201440093fr.pdf.

This bill would define "federal earned income credit amount" as the amount determined under IRC section 32 as amended by several public laws through 2013; however, it would omit the public law enacted in 2014. Accordingly, the state EITC would be determined based on the federal EITC as applicable for tax year 2013. If the author's intent is to base the state EITC on the federal EITC in effect for the taxable, this bill should be amended.

The definition of "qualified taxpayer" includes the undefined phrases "legally working" and "legal work authorization." The absence of definitions to clarify these terms could lead to disputes with taxpayers and would complicate the administration of this credit.

Additionally, this bill would allow a "qualified taxpayer" to use taxpayer identification numbers other than a valid SSN. The bill's allowance of alternative identification numbers would be incompatible with the requirements of federal EITC law, and could complicate the administration of this credit.

This bill would provide that the undefined phrase, "simple error" would be treated as a mathematical error appearing on the return. Existing state law already provides that adjustments to refundable credits are made as math error adjustments.[19] It is unclear whether the author's intent is to provide authority that differs from existing math error authority.

This bill would provide an unlimited carryover period for any excess credit. In addition, this bill would require the department to provide refunds, upon appropriation by the Legislature. It is unclear how the carryover and refund provisions would interact. Additionally, because the bill fails to include an appropriation, if sufficient funds fail to be appropriated to cover all of the refunds due, the department would suspend payment of the refunds until additional funds were appropriated. Interest would have to be paid to refund recipients for the period the refund was delayed. This delay would result in additional contacts to the department by refund recipients, which would likely increase departmental costs.

This bill would require the federal phase out amounts and the excess investment income amount to be annually adjusted by the change in the CCPI. Since these amounts are already adjusted under federal law, it is unclear how the state indexing provision would be applied alongside the federal indexing provision. For example, to what amounts would the CCPI adjustment by applied - the unadjusted statutory amounts in IRC sections 32(b) and (i) or to the federal adjusted amounts for each taxable year? The bill should be amended to clarify the author's intent.

This bill would require the FTB to report to the Legislature beginning January 1, 2017. Since the credit would first be claimed on the 2016 tax return, these returns would be filed and processed in 2017, after the due date of the first report to the Legislature.

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[19] Revenue and Taxation Code section 19052.

TECHNICAL CONSIDERATIONS

On page 3, line 10; a technical amendment should be made to correct a cross-reference.

A technical amendment should be made on page 3, line 36 to remove the possessive in the phrase taxpayer's identification number to correspond to the term used under IRC section 32.

A technical amendment should be made to insert "the" after "exceeds" on page 3, line 40.

The bill includes language that would preclude the refunds received under this bill from being included for purposes of determining eligibility to receive benefits under the Welfare and Institutions Code (WIC). Because this provision does not impact how income tax is calculated or collected, the author may wish to reconsider the placement of this language in the Revenue and Taxation Code.

This bill would grant the FTB the authority to administer enforcement activities, collaborate with EDD, and identify and process high-risk returns using increased verification procedures. Since existing law already provides the FTB this authority, a technical amendment should be made to strikeout this unnecessary language.

A technical amendment should be made to renumber the remaining paragraphs in subdivision (h).

LEGISLATIVE HISTORY

SB 38 (Liu, 2015/2016), would create a refundable EITC equal to 30 or 100 percent of the federal EITC. SB 38 is pending before the Senate Governance and Finance Committee.

AB 43 (Stone, 2015/2016), would create a refundable EITC equal to 15, 35, or 60 percent of the federal EITC, as specified. AB 43 is pending before the Assembly Revenue and Taxation Committee.

SB 1189 (Liu, 2013/2014), would have provided a nonrefundable EITC equal to 15 percent of the federal EITC. SB 1189 failed to pass out of the Senate Appropriations Committee.

AB 1196 (Allen, 2011/2012) and AB 1974 (Dickinson, 2011/2012), would have provided a refundable EITC equal to 15 percent of the federal EITC. AB 1196 and AB 1974 failed to pass out of the Assembly Appropriations Committee.

PROGRAM BACKGROUND – Refundable Tax Credits

The department's experience shows that refundable credits provide an incentive for individuals to commit refund fraud or identity theft to obtain an erroneous refund.

Examples of refund fraud and identity theft include:

- A taxpayer intentionally claiming a credit that exceeds the amount to which they are entitled;
- A tax preparer claiming a credit fraudulently without the taxpayer's knowledge;
- An individual filing a fraudulent return using fictitious information (name and social security number;
- An identify thief filing a fraudulent return using a victim's taxpayer identification number (generally a social security number) and name (including dependent names).

The department has encountered fraud and identity theft related to Wage Withholding as discussed below:

Wage Withhold Related Fraud and Identity Theft

Employers generally withhold state income tax from employee wages, and then submit this state tax withholding to the EDD. The EDD electronically sends FTB information including the amount of state tax withheld. The department uses the EDD data to confirm state income tax withholding reported on a taxpayer's tax return, and if amounts are incorrect, makes an adjustment to the taxpayer's return. Using the information received from the EDD allows the department to detect errors, including fraud, and adjust the return before the money is refunded to the taxpayer.

For decades, the FTB has combated fraudulent attempts to receive an improper refund of state income tax withholding. In the last five years, the FTB has seen a significant increase in identity theft cases in which legitimate withholding is claimed by an identity thief and discovered by the department when the "actual" taxpayer files their tax return and claims the same withholding. In 2013, $7.5 million was improperly refunded due to identity theft.

Identity Theft

According to the U.S. Department of Justice, identity theft is the fastest growing crime in America. The Federal Trade Commission reported an increase of over 50 percent from 2009 through 2011 in tax related identity theft complaints.[20] Unfortunately, California is a prominent participant in those statistics ranking number three in the nation for identity theft complaints.

The IRS continues to increase its efforts against refund fraud, including those resulting from identity theft. The IRS estimates that it prevented $24.2 billion in fraudulent identity theft, but paid $5.8 billion later determined to be fraudulent.[21]

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[20] FTC report titled *Consumer Sentinel Network Data Book for January – December 201.*
[21] U.S. Government Accountability Report 15-119 *Identity and Tax Fraud*. http://www.gao.gov/products/GAO-15-119.

IRS experience also shows that refundable credits provide an incentive for individuals to commit refund fraud or identity theft to obtain an erroneous refund as discussed below.

Federal Refundable Earned Income Tax Credit (EITC)

The IRS has historically experienced a high rate of improper payments with refundable credits. The improper payments can stem from honest mistakes; however many are related to fraud and identity theft. A significant portion is from misreporting self-employment income.

For tax year 2012, the IRS estimated that it paid $63 billion in refundable EITCs and that an estimated 24 percent of all EITC payments made in Fiscal Year 2013, or $14.5 billion, were paid in error.[22] Recently, the Governmental Accountability Office has reported that for Fiscal Year 2014, the EITC error rate has increased to 27 percent.[23]

The federal EITC program has been declared a high-risk program by the Office of Management and Budget. According to the Treasury Inspector General, despite IRS efforts of education and outreach, enforcement actions, and the paid tax return preparer compliance initiative, the estimated EITC improper payment rate has remained "relatively unchanged," and the dollar amount of EITC claims paid in error has grown between fiscal year 2003 and fiscal year 2013.[24]

Legislative Analyst Office (LAO) Report

On December 18, 2014, the LAO issued a report on the "Options for a State Earned Income Tax Credit."[25] This report discussed the option to "piggyback" on the federal EITC, and the IRS history of improper payments with the federal EITC.

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 have personal income tax, and therefore does not provide a tax credit comparable to the credit proposed by this bill.

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[22] TIG Report *Existing Compliance Processes Will Not Reduce the Billions of Dollars in Improper Earned Income Tax Credit and Additional Child Tax Credit Payments*, dated September 29, 2014. Reference Number 2014-40-093.
[23] GAO Report 15-482T *Improper Payments*. http://www.gao.gov/assets/670/669026.pdf
[24] TIG *Existing Compliance Processes Will Not Reduce the Billions of Dollars in Improper Earned Income Tax Credit and Additional Child Tax Credit Payments*, dated September 29, 2014. Reference Number 2014-40-093.
Fiscal Year 2003 improper EITC payments totaled from $9.5 billion to $11.5 billion as compared to Fiscal Year 2013 improper EITC payments estimated at $14.5 billion
http://www.treasury.gov/tigta/auditreports/2014reports/201440093fr.pdf

[25] http://www.lao.ca.gov/reports/2014/finance/state-eitc/options-state-eitc-121814.pdf

Illinois allows taxpayers to claim a refundable credit equal to 10 percent of their federal EITC.

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

Michigan allows taxpayers to claim a refundable credit equal to 6 percent of their federal EITC.

Minnesota allows taxpayers to claim a Working Family Credit (WFC) if they also claimed the federal EITC. The WFC is based on the lesser of either the federal EITC or federal AGI.

New York allows taxpayers to claim a refundable credit equal to 30 percent of the federal EITC.

FISCAL IMPACT

Costs to administer this bill have yet to be determined. As the bill continues to move through the legislative process and the implementation concerns are resolved, costs will be identified and an appropriation will be requested, if necessary. Because the bill would provide a refundable credit, the costs are anticipated to be significant.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue loss:

Estimated Revenue Impact of SB152 As Amended March 16, 2015 Enactment Assumed After June 30, 2015 ($ in Millions)			
	2015-16	2016-17	2017-18
Assuming No Appropriation	- $24	- $120	- $120
Assuming An Appropriation is made	- $240	- $1,200	- $1,200

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

Revenue Discussion

3.2 million California taxpayers claimed approximately $7.5 billion in federal EITC for taxable year 2012. As such, the CA EITC would be 15 percent of the federal EITC, or approximately $1.1 billion. Should the legislature choose to appropriate funds for the refundable credit, the loss would be $1.1 billion, including any existing tax offsets. Without appropriation authority, it is estimated that only 10 percent, or $110 million, would be used to offset tax.

These totals are grown using the Department of Finance personal income tax growth rates, fiscalized, and then rounded to reach the numbers in the table above.

This analysis assumes that California will not apply an additional CCPI inflation adjustment because the Federal amount already includes one.

SUPPORT/OPPOSITION

Proponents: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some may say that in a time when many low- to middle-income working families are living in poverty, this credit would provide financial assistance to these families and stimulate the economy.

Opponents: Some may argue that providing a tax credit limited to low- to middle-income families may be overly narrow and inadvertently exclude other Californians that need assistance.

POLICY CONCERNS

The department is concerned that a state refundable credit based on the federal EITC that has a history of improper payments could exacerbate the trend in refund fraud and identity theft.

Although this credit would not be limited to residents of California, the actual state EITC for a nonresident could be zero. Generally, credits for nonresidents and part-year residents are prorated based on the ratio of California taxable income to total taxable income. To the extent that a nonresident claimed the state EITC proposed by this bill, but did not have any California earned income, the ratio would be zero. Consequently, the amount of the allowable state EITC would be zero.

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