Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Liu	Analyst:	Jessica Deitchman	Bill Number:	SB 38
Related Bills:	See Legislative History	Telephone:	845-6310	Amended Date:	March 23, 2015
		Attorney:	Bruce Langston	Sponsor	

SUBJECT:	Earned Income Refundable Credit/FTB Establish An Advance Earned Income Credit Payment Pilot Program & Study & Report Findings of Pilot Program/Tax Preparing Curriculum for Recipients

SUMMARY

This bill would, under the Personal Income Tax Law (PITL), create a refundable California earned income tax credit (EITC) and require the Franchise Tax Board (FTB) to establish an advance payments pilot program.

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

RECOMMENDATION

No position.

Summary of Amendments

The March 23, 2015, amendments added provisions that would make the proposed state EITC refundable and require the FTB to establish and administer an advance payment pilot program. This analysis replaces the department's analysis of this bill as introduced on December 1, 2014.

Summary of Suggested Amendments

Technical amendments are suggested to provide clarity on how the EITC program should be administered.

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

This bill would be effective January 1, 2016, and specifically operative for taxable years beginning on or after January 1, 2016 and before January 1, 2027.

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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.

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

An eligible individual[3] 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[4] must have a social security number (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] The maximum amount of investment income a taxpayer can have and still get the credit is $3,350 in 2014.
[2] Internal Revenue Code (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(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 prepares 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.[5]

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 SSNs. 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.[6] 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. In addition, it provides that adjustments of refundable credits are made as math error adjustments[7], not refund claim denials. Taxpayers must file a separate new refund claim if they disagree with the adjustment.

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.

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[5] Treas. Reg. 1.6695–2 Tax return preparer due diligence requirements for determining earned income credit eligibility.

[6] However, *The Earned Income Tax Credit Information Act* (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.

[7] R&TC section 19052.

THIS BILL

EITC

For taxable years beginning on or after January 1, 2016, and before January 1, 2027, this bill would provide a state EITC, in an amount computed by multiplying the "federal earned income credit amount" by either:

- 30 percent for eligible individuals with qualifying children, or
- 100 percent for eligible individuals with no qualifying children

"Federal earned income credit amount" would mean the amount determined under Section 32 of the Internal Revenue Code (IRC).[8]

"Eligible Individual" would have the same meaning as in Section 32(c)(1)[9] of the IRC, except the provision[10] that requires an individual without a qualified child to be at least 25 years of age is modified to be at least 21 years of age.

Any allowable credit in excess of state tax liability would be either:

- Carried over to succeeding taxable years until exhausted, or
- Credited against other amounts due, if any, and the balance, upon appropriation by the Legislature, be paid from the General Fund and refunded to the qualified taxpayer.

Any amounts refunded to a taxpayer under this bill would not be included in income.

For an individual who is a nonresident or is a part-year resident of this state, that amount of the credit or refund allowed under this bill would be determined based on the part of the earned income credit allowable for the taxable year that is attributable to California, determined by multiplying the federal earned income credit by a fraction as follows:

- The numerator of which is the California AGI of the individual
- The denominator of which is the federal AGI of the individual

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[8] As amended by Section 1002(a) of Public Law 111-5, as amended by Section 219(a)(2) of Public Law 111-5, as amended by Section 219(a)(2) of Public Law 111-226, as amended by Section 103(c) of Public Law 111-312, and as amended by Section 103(c) of Public Law 112-240.

[9] Section 32(c)(1) of the IRC defined "eligible individual" as any individual who has a qualified child for the taxable year or any individual who does not have a qualified child for the taxable year if such individual's principal place of abode is the US for more than ½ of the taxable year and such individual is at least age 25 but is less than age 65 before the end of the taxable year and such individual is not a dependent for whom a deduction is allowed to another taxpayer for any taxable year beginning in the same calendar year as the tax year.

[10] Section 32 (c)(1)(A)(ii)(II) of the IRC.

Additionally, this bill would require the FTB to submit a report to the legislature on or before January 1, 2026, that would include information on the effectiveness of the credit including:

- The amount of the credit claimed,
- The number of claims made, and
- An estimate of the amount overclaimed and underclaimed.

Additionally, the bill states that for purposes of determining eligibility to receive benefits[11], any refund made to an individual and any payment made to an individual would not be treated as income and would not be taken into account in determining resources for the month of its receipt and the following month.

Section 41 would not apply to the credit allowed by this bill.[12]

The EITC would be repealed on December 1, 2027.

Pilot Program

This bill would require the FTB to establish a pilot program to allow eligible individuals to secure advance payments of the EITC. The bill would specify the following:

- The pilot program would apply to any credit for which a taxpayer is an eligible individual on or after taxable years January 1, 2017, and before January 1, 2019, where an employer and an eligible individual have agreed to participate in the pilot program.
- Not later than January 1, 2020, the FTB would study the pilot program and report the findings of the pilot program to the Legislature.
- The pilot program would be repealed on December 1, 2020.

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 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 the FTB could

[11] Under Division 9 (commencing with Section 10000) of the Welfare and Institutions Code.

[12] The R&TC section 41 requires any new tax credit legislation introduced on or after January 1, 2015, to include specific goals, purposes, objectives, and performance measures.

implement a refundable credit of this magnitude without causing risk to the EDR project would be after process year 2017.[13]

The bill uses terms that are undefined, "California Adjusted Gross Income", and "qualified taxpayer." The absence of definitions to clarify these terms could lead to disputes with taxpayers and would complicate the administration of this credit.

Many taxpayers eligible for the federal EITC have no California income tax return filing requirement. These non-filers 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[14] 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 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.

The department would be required to provide refunds, upon appropriation by the Legislature; however, the bill fails to include an appropriation, or a date when the appropriation must be made. 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. If the bill were amended to provide for a continuous appropriation, this implementation concern would be resolved.

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[13] 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.

[14] 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.

To implement the state EITC and the pilot program for advance payments of the EITC, the department would need to promulgate regulations prior to the 2016 filing season. Because the bill fails to specify otherwise, the FTB would be subject to the rulemaking procedures required under the Administrative Procedure Act (APA).[15] Following these procedures may delay the immediate implementation of both the EITC and pilot program provisions 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, guidelines, or procedures necessary or appropriate to carry out the purpose of this bill.

This bill lacks administrative details necessary to implement the pilot program for advance payments specified in the bill and determine its impacts to the department's systems, forms, and processes. The bill is silent on the following issues:

- A funding mechanism for the FTB's start-up and on-going costs to administer the pilot program provisions of this bill. Absence of a funding mechanism could delay implementation or require diversion of resources from existing revenue generating workloads.
- A funding mechanism for employers to fund advance payments during the pilot program.
- The entity authorized to determine a taxpayer's eligibility for participation in the pilot program.

It is recommended that the bill be amended to provide clarity on these issues and ensure consistency with the author's intent.

TECHNICAL CONSIDERATIONS

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. 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 Tax Code.

For clarity on what taxable years should be included in the newly created pilot program, the following amendment is recommended:

On page 6, line 19, revise line 19 as follows:

17052.1, <u>for taxable years beginning </u>on or after ~~taxable years~~ January 1, 2017, and before

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[15] Government Code section 11340 et seq.

LEGISLATIVE HISTORY

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

SB 152 (Vidak, 2015/2016), would create a refundable EITC equal to 15 percent of the federal EITC. SB 152 is pending before the Senate Governance and Finance 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 the taxpayer is entitled;
- A tax preparer claiming a credit fraudulently without the taxpayer's knowledge;
- An individual filing a fraudulent return using fictitious information (name and SSN); and
- An identify thief filing a fraudulent return using a victim's taxpayer identification number (generally an SSN) 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 Employment Development Department (EDD). The EDD electronically sends the FTB a list of taxpayers with the amount of state tax withheld. The department uses the EDD information 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.

For decades, the FTB has combated fraudulent attempts to receive an improper refund of state income tax withholding. 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.

In the last five years, the FTB has seen a significant increase in identity theft cases, where legitimate withholding is claimed by an identity thief and discovered by the department only 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 (FTC) reported an increase of over 50 percent from 2009 through 2011 in tax related identity theft complaints.[16] 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.[17]

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.[18] Recently, the Governmental Accountability Office has reported that for Fiscal Year 2014, the EITC error rate has increased to 27 percent.[19]

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.[20]

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[16] FTC report titled *Consumer Sentinel Network Data Book for January – December 2011.*
[17] U.S. GAO Report 15-119 *Identity Theft and Tax Fraud*. http://www.gao.gov/products/GAO-15-119.
[18] 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.
[19] U.S. GAO Report 15-482T *Improper Payments.* http://www.gao.gov/assets/670/669026.pdf.

[20] 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.

Legislative Analyst Office (LAO) Report

On December 18, 2014, the LAO issued a report on the "Options for a state EITC."[21] This report discussed the option to "piggyback" on the federal EITC, and also discussed the IRS history of improper payments with the federal EITC.

IRS Advance Payments[22]

For taxable years beginning before January 1, 2011, the IRS offered advance EITC payments to eligible taxpayers via advances in their paychecks. Taxpayers (employees) submitted IRS form 941 and when approved, provided a copy to their employers. This form included the taxable year that the employee was qualified for the EITC and the dollar amount of the credit that should be advanced monthly. Upon receipt of this form, the employer was required to pay the employee the specified amount of EITC in their paycheck. The employer received the funds to pay the employee by reducing the amounts paid to the IRS from tax withholding, FICA taxes, and employer FICA taxes.

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.

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.

[21] http://www.lao.ca.gov/reports/2014/finance/state-eitc/options-state-eitc-121814.pdf.
[22] Further information can be found at https://www.law.cornell.edu/cfr/text/26/31.3507-1.

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 SB 38 As Amended March 23, 2015 Enactment Assumed After June 30, 2015 ($ in Millions)			
	2015-16	2016-17	2017-18
Assuming No Appropriation	- $60	- $300	- $350
Assuming An Appropriation is Made and Refunds Are Issued	- $600	- $2,900	- $3,000

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

Revenue Discussion

EITC Provision

Approximately $7.5 billion in federal EITC was claimed by 3.2 million California taxpayers in the 2012 taxable year. Using data from the IRS Individual Statistical Tables, this amount is increased $600 million to account for the modified definition of an eligible taxpayer to include taxpayers between the ages of 21 to 25 for an estimated total of $8.1 billion. Data from the IRS indicates that approximately 97 percent of EITC is claimed by taxpayers with at least one qualified child with the remaining 3 percent claimed by taxpayers without a qualifying child. Applying the credit rates specified in this bill would generate approximately $2.5 billion in California EITC for 2012. Should the legislature choose to appropriate funds for a refundable credit, the loss would be $2.5 billion, including any existing tax offsets. Without appropriation authority, it is estimated that 10 percent of this amount would be used to offset tax in the year generated and the remainder would be utilized in future years.

The tax year estimates are grown[23], fiscalized, and rounded to reach the amounts shown in the table above.

Pilot Program Provision

A revenue estimate cannot be determined until the scope of the pilot area is defined and the technical and implementation considerations discussed above have been addressed.

SUPPORT/OPPOSITION

Support: 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.

This bill provides a state credit in an amount equal to up to 100 percent of the federal EITC. In general, a taxpayer's federal income tax liability is significantly higher than his or her state income tax liability. As a result, a state tax credit for an individual that would be equal to 100 percent of the federal credit could be considered to provide a greater proportionate benefit for state tax purposes than for federal tax purposes.

This credit would be calculated as a percentage of the federal EITC with the highest percentage allowed to an eligible individual with no qualifying children. If this is contrary to the author's intention, the author may wish to amend this bill.

[23] Indexed using Department of Finance forecasts.

Although this credit would not be limited to residents of California, the actual state EITC for a nonresident could be zero. To the extent that a nonresident claimed the state EITC proposed by this bill, but did not have any California taxable income, the ratio would be zero. Consequently, the amount of the allowable state EITC would be zero.

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