Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Liu	Analyst:	Davi Milam	Bill Number:	SB 38
Related Bills:	See Legislative History	Telephone:	845-2551	Amended Date:	June 2, 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).

RECOMMENDATION

No position.

Summary of Amendments

The June 2, 2015, amendments removed the provisions of the bill as amended May 6, 2015, and replaced them with the provisions discussed in this analysis. This analysis replaces the department's analysis of the bill as amended May 6, 2015.

REASON FOR THE BILL

The reason for the bill is to help the poorest working families in California by providing a refundable state EITC that complements the existing federal EITC.

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, 2015.

The bill would only be operative for taxable years for which an adjustment factor is specified in the annual Budget Act and in which resources are authorized in the annual Budget Act for the Franchise Tax Board (FTB) to oversee and audit returns associated with the credit.

Federal Law

Existing federal law (Section 32 of the Internal Revenue Code (IRC)) 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.

Board Position:						Executive Officer	Date
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Earned income generally includes two categories of income:[1]

- Wages, salaries, tips, and other employee compensation, and
- Net-earnings from self-employment.

A taxpayer may also elect to include combat pay that is otherwise excludable from gross income. Certain other income, such as pensions and inmate pay, are excludable as earned income for purposes of computing the EITC.[2]

The credit percentage varies, based on whether the taxpayer has qualifying children. The federal credit rate for the 2015 taxable year varies from 7.65 percent to 45 percent, depending on the number of qualifying children.

In the case of an eligible individual with:	The credit percentage is:	The phaseout percentage is:
No qualifying children	7.65%	7.65%
1 qualifying child	34%	15.98%
2 qualifying children	40%	21.06%
3 or more qualifying children	45%[3]	21.06%

The 2015 earned income amounts at which the EITC is fully phased-in and the phaseout amounts at which the EITC is completely phased-out are shown below:

An eligible individual with:	Earned Income Amount (Maximum Credit Fully Phased-In)[4]	Completely Phased-Out at:[5]	2015 Max. Credit
No qualifying children	$6,580	$14,820 ($20,330 if married filing jointly)	$503
1 qualifying child	$9,880	$39,131 ($44,651 if married filing jointly)	$3,359
2 qualifying children	$13,870	$44,454 ($49,974 if married filing jointly)	$5,548
3 or more qualifying children[6]	$13,870	$47,747 ($53,267 if married filing jointly)	$6,242

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[1] IRC section 32(c)(2)(A).
[2] IRC section 32(c)(2)(B).
[3] The 45 percent credit rate is applicable to taxable years beginning after 2008 and before 2018.
[4] For 2015, this is the level of earned income at which the maximum federal EITC is fully phased-in. This earned income level is the same regardless of filing status. An eligible individual will continue to receive the maximum federal EITC even as earned income increases through the plateau range. Then, the credit begins to phaseout as earned income increases.
[5] Under IRC section 32(a)(2)(B) the credit is phased-out based on adjusted gross income (AGI), or, if greater, the earned income.

An eligible individual[7] is defined as follows:

- Any individual who has a qualifying child for the taxable year, or
- Any other individual that does not have a qualifying child for the taxable year, if they meet the following requirements:[8]
    - Have attained the age of 25 but not attained the age of 65 before the close of the taxable year.
    - Have a principal place of abode in the United States for more than one-half the taxable year.
    - Not be a dependent of another taxpayer.

Certain individuals are specifically excluded from the definition of an eligible individual.[9]

Generally, a qualifying child must live with the eligible individual for more than one-half the taxable year in the United States, 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. The name, age, and Social Security Number (SSN) of the qualifying child must be reported on the tax return.

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

Federal law requires the use of tables to determine the amount of the EITC based on earned income brackets, filing status, and the number of qualifying children, if any.

No credit is allowed if the aggregate amount of investment income of the taxpayer for the taxable year exceeds a specific amount. For taxable year 2015, that adjusted amount is $3,400. Examples of investment income are interest, dividends, and capital gains.

The earned income, phaseout, and investment income threshold amounts are increased each taxable year by the cost-of-living adjustment.

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[6] IRC section 32(b)(3) provides special rules for taxable years beginning 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.
[7] IRC section 32(c)(1).
[8] IRC section 32(c)(1)(A)(ii).
[9] IRC section 32(c)(1) excludes from the definition of an eligible individual: an individual who is a qualifying child of another taxpayer; U.S. citizens or residents living abroad and claiming benefits of IRC section 911, and most nonresident aliens, unless they elect to be treated as US residents for federal tax purposes.

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.

Existing federal law requires paid preparers who prepare tax returns claiming the federal EITC to perform certain due diligence requirements. A penalty of $500 is imposed for each failure to satisfy the due diligence requirements.[10]

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 SSN verification process. By its terms, this federal law applies to states that allow an EITC.

An eligible individual (and spouse, if filing a joint return) and qualifying child must have a valid SSN issued by the Social Security Administration.

State Law

California does not provide an EITC.[11] 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 that adjustments of refundable credits are made as math error adjustments[12], not deficiency assessments or refund claim denials. Taxpayers may file a separate new refund claim to contest 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, the most recent year information is available; 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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[10] Treas. Reg. 1.6695–2 Tax return preparer due diligence requirements for determining earned income credit eligibility.
[11] 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.
[12] R&TC section 19052.

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.

THIS BILL

For each taxable year beginning on or after January 1, 2015, this bill would provide a refundable state EITC in an amount equal to an amount determined in accordance with Section 32 of the IRC as applicable for federal income tax purposes for the taxable year, except as discussed below.

The amount of the credit would be multiplied by the EITC adjustment factor for the taxable year. Unless otherwise specified in the annual Budget Act, the EITC adjustment factor for taxable years beginning on or after January 1, 2015, would be zero percent. (For taxable year 2015, the EITC adjustment factor in the Budget Act is proposed to be 85 percent).[13]

The EITC would only be operative for taxable years for which resources are authorized in the annual Budget Act for the FTB to oversee and audit returns associated with the credit.

The state credit percentages would match the federal credit percentages (7.65 percent to 45 percent), but the state EITC would phaseout at different percentages as shown in the table below.

In the case of an eligible individual with:	The credit percentage is:[14]	The phaseout percentage is:
No qualifying children	7.65%	7.65%
1 qualifying child	34%	34%
2 qualifying children	40%	40%
3 or more qualifying children[15]	45%	45%

For purposes of computing the state EITC, the following earned income and phaseout amounts would apply in lieu of the federal amounts.[16] For the 2015 taxable year, the maximum state EITC (after applying the proposed 85 percent EITC adjustment factor) would range from $214 for an eligible individual without a qualifying child to $2,652 for an eligible individual with three or more qualifying children.

[13] Based on the Department of Finance Fact Sheet.
[14] Agrees to the federal credit percentages.
[15] Temporary 45 percent credit percentage applicable for taxable years beginning after 2008 and before 2018.
[16] Prescribed in IRC Section 32(b)(2)(A).

In the case of an eligible individual with:	Earned Income Amount (Maximum Credit Fully Phased-In):[17]	The Phaseout Amount is:	Completely Phased-Out at:[18]	Maximum State EITC (before EITC adjustment factor)	Maximum State EITC (with 85% proposed EITC adjustment factor)[19]
No qualifying children	$3,290	$3,290	$6,580	$252	$214
1 qualifying child	$4,940	$4,940	$9,880	$1,680	$1,428
2 qualifying children	$6,935	$6,935	$13,870	$2,774	$2,358
3 or more qualifying children	$6,935	$6,935	$13,870	$3,120	$2,652

The maximum amount of investment income a taxpayer could have and still remain eligible for the credit would be $3,400 in 2015. This bill would generally conform to the types of disqualified investment income under federal law.

The earned income, phaseout, and investment income amounts would be adjusted annually for inflation for taxable years beginning on or after January 1, 2016, in the same manner as the recomputation of the state income tax brackets.[20]

This bill would conform to the federal definitions of an "eligible individual and a "qualifying child" with the following exceptions:

- An eligible individual without a qualifying child would be required to have a principal place of abode in "this state" (rather than the United States) for more than one-half of the taxable year.
- A qualifying child also would be required to have a principal place of abode in "this state" (rather than the United States) for more than one-half of the taxable year.

For purposes of the state EITC, the definition of "earned income" would be modified to include wages, salaries, tips, and other employee compensation, but only if such amounts are subject to California withholding.[21] Additionally, earned income would specifically exclude income from self-employment.

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[17] This is the earned income level at which the maximum state EITC is received. Unlike the federal credit, the state credit will immediately begin to phaseout at income above this level.
[18] For the 2015 taxable year, the state EITC will be completely phased-out at the income level at which the maximum federal EITC is fully phased-in. Refer to Table in *Federal Law*, page 3, column 2.
[19] The EITC adjustment factor would be updated should the percentage change in the Budget Act.
[20] Under R&TC section 17041(h).
[21] Pursuant to Division 6 (commencing with section 13000) of the Unemployment Insurance Code.

This bill would generally conform to the types of income excludable as earned income for purposes of computing the EITC.

Any allowable credit in excess of state tax liability would be credited against other amounts due, if any, and the balance, if any, would be paid from the Tax Relief and Refund Account and refunded to the taxpayer.

This bill also would provide the following:

- The FTB may prescribe rules, guidelines, or procedures necessary or appropriate to carry out the purposes of this section. The rules, guideline or procedures would be exempt from the Administrative Procedure Act.
- A waiver of the estimate penalty, if the underpayment was attributable to the adjustment factor for the taxable year being less than the adjustment factor for the preceding taxable year. The waiver would apply to penalties imposed on or after January 1, 2016.
- Conform to the $500 penalty for paid preparers who fail to comply with the due diligence requirements for determining eligibility for EITC.

In addition, for purposes of implementing the state EITC for the 2015 taxable year, this bill would exempt the FTB from specified requirements under the State Administrative Manual, the Statewide Information Management Manual, the 2015 Budget Act, and the Public Contract Code.

The FTB would be required in its next anticipated Special Project Report for its Enterprise Data to Revenue Project to incorporate the scope, costs, and schedule changes associated with the implementation of the state EITC.

LEGISLATIVE HISTORY

AB 43 (Stone, 2015/2016), would create a refundable EITC equal to a percentage of the federal EITC. AB 43 is pending before the Senate.

SB 152 (Vidak, 2015/2016), would create a refundable EITC equal to a percentage of the federal EITC. SB 152 failed to pass out of the Senate Appropriations 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.

AB 21 (Jones, 2007/2008), 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.

PROGRAM BACKGROUND – Refundable Tax Credits

Legislative Analyst Office (LAO) Report

On December 18, 2014, the LAO issued a report on the “Options for a State Earned Income Tax Credit.”[22] This report discussed the option (referred to as “Option 2”) to provide a state EITC that matched the federal EITC for working families at the lowest income levels. The report also discussed the IRS history of improper payments with the federal EITC.

This bill would create a state EITC similar to “Option 2;” however, this bill would modify earned income eligible for the credit by requiring wages, salaries, tips, and other employee compensation to be subject to withholding in this state and would exclude income from self-employment.

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.

FISCAL IMPACT

Staff estimates a cost of approximately $22 million for fiscal year 2015/2016, $11.6 million for fiscal year 2016/2017, and ongoing costs of $10.1 million beginning for fiscal year 2017/2018 to provide the department with the resources to build the necessary system infrastructure, respond to taxpayer and tax preparer questions, provide education and outreach, review returns, and prevent improper refunds from being issued. The department is pursuing a budget change proposal for these costs.

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

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue loss:

Estimated Revenue Impact of SB 38 As Amended June 2, 2015 Assumed Enactment After June 30, 2015 ($ in Millions)		
2015-16	2016-17	2017-18
- $380	- $390	- $400

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

Revenue Discussion

The revenue effect of this bill was estimated from federal data on the amount of EITC claimed by various income groups. For each income group, the federal amount was modified to account for California's portion of the federal population by applying the earned income amounts and limitations specified in this bill and the ratio of state to federal credit available to that income group. The estimated revenue loss is expected to be in the range of $380 - $400 million for taxable year 2015.

This total was grown[23] and rounded to reach the numbers in the table above.

SUPPORT/OPPOSITION[24]

Proponents: Alameda County Board of Supervisors, American Academy of Pediatrics, California, American Association of University Women, California Association of Food Banks, California Catholic Conference of Bishops, California Food Policy Advocates, California Hunger Action Coalition, California Partnership, California Reinvestment Coalition, Children's Defense Fund – California, Coalition of California Welfare Rights Organization, Community Action Partnership of Kern, Community Action Partnership of Riverside County, Courage Campaign, Friends Committee on Legislation of California, Lutheran Office of Public Policy – California, National Association of Social Workers, California Chapter, Pacoima Beautiful, PolicyLink, Ventura County Board of Supervisors, Western Center on Law and Poverty.

Opposition: California Taxpayers Association.

[23] Based on historical federal credit usage by California taxpayers.
[24] As noted in Senate Floor analysis dated June 2, 2015.

ARGUMENTS

Proponents: Some may say that in a time when many low-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-income families may be overly narrow and inadvertently exclude other Californians that need assistance.

LEGISLATIVE STAFF CONTACT

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