Pursuant to the Legislative Analyst's Office Supplemental Report of the 2015-16 Budget Package, the Franchise Tax Board (FTB) is required, after implementation activities have been completed for the California Earned Income Tax Credit, to explore methods that could be considered to allow self-employment income to be included as earned income while protecting against improper payments. This information shall be provided to staff of the budget committees.

The following information is submitted to satisfy the above reporting requirement.

Program Background:

Federal Earned Income Tax Credit

Federal law has allowed a refundable earned income tax credit (EITC) since 1975.[1] The federal EITC is a percentage of earned income, and varies based on filing status and the number of qualifying children. "Earned Income" generally includes two categories of income:

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

The Internal Revenue Service (IRS) has historically experienced a high rate of improper claims with the EITC; estimates range from 29 percent to 39 percent.[2] The IRS Compliance Study of the EITC claimed on 2006 to 2008 returns shows that the most common errors are qualifying child errors and income misreporting.[3] According to this study, only 24 percent of returns claiming the EITC are based on self-employment (SE) income, yet income misreporting is the second biggest contributor to improper claims. The value of improper claims from misreporting SE income is approximately four times greater than the value of improper claims from misreporting wage income.[4]

According to IRS data, "income misreporting is known to be strongly associated with the extent to which income information is reported to the IRS by a third-party. SE income has very little information reporting while wage income is subject to heavy information reporting as well as withholding."[5] IRS Tax gap research has shown the link "between third-party information reporting and reporting noncompliance."[6]

[1] Internal Revenue Code (IRC) section 32. For additional information on the federal EITC go to www.irs.gov.
[2] Legislative Analyst's Office (LAO) report, *Options for a State Earned Income Credit*, December 19, 2014.
[3] *Compliance Estimates for the EITC Claimed on 2006-2008 Returns (IRS EITC Compliance Study)*, page 20. Qualifying child errors are the number one cause for overclaims (accounts for 42 to 54 percent of total overclaims) and income misreporting is the second largest cause of overclaims (24 to 32 percent).
http://www.irs.gov/PUP/individuals/EITCComplianceStudyTY2006-2008.pdf
[4] *IRS EITC Compliance Study*. Misreporting self-employment income accounts for 15 to 23 percent of overclaims; while misreporting wage income accounts for three to six percent of overclaims and is the least significant cause of overclaims.
[5] *IRS EITC Compliance Study,* page 18.
[6] *www.irs.gov/pub/irs-utl/tax_gap_update_070212.pdf*

Income from SE for sole proprietors is reported on IRS Schedule C *Profit or Loss from Business* (sole proprietorship). According to IRS data, the most common errors related to misreporting SE income on Schedule C *Profit or Loss from Business* are:

- Overstated Schedule C losses or expenses which reduce earned income in order to qualify for EITC.
- Overstated Schedule C income to maximize the amount of the EITC, and
- Fictitious Schedule C income to qualify for or maximize the amount of the EITC.

IRS Compliance Efforts

Over 60 percent of returns claiming the EITC are prepared by paid tax preparers; thus, the IRS has implemented the **Paid Preparer's Due Diligence Program** using compliance techniques aimed at paid tax preparers, including:

- **IRS Form 8867** ***Paid Preparer's Earned Income Checklist:***
  Paid tax preparers must complete and attach IRS Form 8867 for each return claiming the EITC. This form requires paid preparers, among other requirements, to identify the taxpayer-provided documents the preparer relied upon to prepare the Schedule C. Failure to meet the due diligence requirements can result in a preparer penalty in an amount equal to $500 per return.[7]

- **Web Support for Paid Tax Preparers,** including:
  - Online Publication 4933 *Tax Preparer's Guide to Everything Earned Income Tax* Credit provides resources for paid preparer's through "The Tax Preparer Toolkit" including links to:[8]
    - *EITC Schedule C and Record Reconstruction Training*.
      This site advises paid preparers to take additional steps to determine that net SE income is correct and does not over-report or under-report income.
    - *Due Diligence Best Practices Training and Videos.*[9]
  - IRS Webinar: *Keeping Up with Earned Income and Refundable Credits* instructs paid preparers on how to meet the due diligence requirements and how to avoid the most common errors.[10]

- **EITC Due Diligence Enforcement Strategies**, including :
  - IRS "Warning" letters to paid tax preparers who failed to attach Form 8867 *Paid Preparer's Earned Income Checklist* or who prepared multiple questionable EITC claims.
  - Barring Non-Compliant Paid Preparers from filing federal tax returns through injunctions where other compliance efforts have failed. Such preparers could face criminal charges and/or other penalties.

---

[7] https://www.irs.gov/pub/irs-pdf/f8867.pdff
[8] (http://www.eitc.irs.gov/Tax-Preparer-Toolkit/sctraining).
[9] (https://www.eitc.irs.gov/training/login/auth
[10] http://www.irsvideos.gov/KeepingUpWithEarnedIncomeRefundableTaxCredits/

In addition to the ***Paid Preparer Due Diligence program***, the IRS employs the following taxpayer compliance techniques related to SE income:

- **Use of correspondence**, including:
  - Form 11652 *Questionnaire and Supporting Documentation Form 1040 Schedule C (Profit and Loss from Business)* to request information to verify the accuracy of the taxpayer's Schedule C for purposes of claiming the EITC, including license requirements, records maintained, and income reports such as Form 1099-MISC. http://www.eitc.irs.gov/EITCCentral/F11652.pdf
  - IRS Letter 5621 (12-2015) that asks taxpayers claiming the EITC based on SE income to review their tax return to ensure the Schedule C is accurate. Taxpayers are requested to file an amended return, if upon their own review, they find that income and expenses reported on the Schedule C are incorrect. https://www.eitc.irs.gov/EITCCentral/static_assets/5621a.pdf
- **Restrictions on Noncompliant Taxpayers**:
  - Federal law restricts taxpayers from claiming the EITC for a period of two years or ten years where the IRS determines the EITC claim was due to reckless/intentional disregard of rules and regulations or fraud.[11] Among the reasons for this determination, IRS includes "apparently false W-2 Forms or Schedules Cs" as examples of fraud.

Despite these efforts, the Treasury Inspector General (TIG) reports that the estimated EITC improper payment rate has remained "relatively unchanged," and the dollar amount of the EITC claims paid in error has grown between fiscal year 2003 and fiscal year 2013 ($10.5 billion to $ 14.5 billion).[12]

Recently enacted federal legislation provides the IRS with additional compliance tools including the following:

- Effective for the 2017 filing season, the IRS will delay EITC refund requests until February 15, 2017, to allow more review time to minimize fraud and improper payments.[13]
- Effective for claims filed after December 31, 2015, the 20 percent penalty for excessive claims for refund or credit will apply to the refundable portion of credits.[14]

[11] IRC 32 (k). The Internal Revenue Manual (IRM) lists "apparently false W-2 Forms or Schedule Cs" as examples of fraud. IRM, 4.19.14.6.1 ¶ 8.
[12] TIG Report *Existing Compliance Processes Will Not Reduce the Billions of Dollars in Improper EITC and Additional Child Tax Credit Payments*, dated September 29, 2014. Reference Number 2014-40-093.
[13] Protecting Americans from Tax Hikes Act of 2015 (PATH Act), Section 201.
[14] PATH Act, Section 209 also eliminates the exception from the penalty for erroneous refunds and credits that currently applies to the EITC, and the provision provides reasonable-cause relief from the penalty. IRC section 6676. California law does not conform to this change.

***State Earned Income Tax* Credits**

California along with 24 other states and the District of Columbia offer an EITC. Most state EITCs are refundable and are based on a percentage of the federal EITC amount.[15] The California EITC, enacted in 2015, is generally modeled after federal eligibility rules with modifications.[16] However, unlike most other state EITCs, the California EITC is not a percentage of the federal EITC amount. Rather, the California EITC limits earned income to wages, salaries, tips, and other employee compensation that are includable in federal gross income and that are subject to California withholding. Additionally, the California EITC is only available to California households with adjusted gross incomes (AGI) of less than:[17]

- $6,580 if there are no qualifying children,
- $9,880 if there is one qualifying child, or
- $13,870 if there are two or more qualifying children.

Other States' EITC Compliance Efforts

The Legislative Analyst's Office (LAO) in the report, *Options for a State Earned Income Tax Credit,* noted in the review of "EITC Enforcement Activities in Other States" that states focused on "preventing improper payments before they happen rather than on recovering them after sending them out." The LAO report identified the following methods used by states to minimize improper payments:[18]

- Stopping payment of refunds in cases where the claims have a high likelihood of containing errors until the claim can be verified.
- Developing methodologies to flag claims that fit certain criteria that would indicate higher likelihood of a common error, such as reporting SE income in an amount that provides the maximum EITC benefit.

Additionally, the LAO report noted that EITC enforcement activities vary across states, but that New York reports that during peak season they have over 100 staff devoted to enforcement activities related to processing about 1.6 million state EITC claims. New York offers an EITC equal to 30 percent of the federal EITC, which includes SE income in earned income.

Prior to implementing the new California EITC, department staff met with representatives from the New York State Department of Taxation and Finance. New York state representatives indicated that their state uses predictive models and business rules in return processing to protect against improper payments related to EITC claims. In their experience, fictitious or unverifiable SE income was one of the primary reasons for improper EITC payments. Limiting the EITC to wage only-earned income would be an effective method of reducing improper payments due to the ability to reliably match taxpayer-reported wage income against employer-provided wage data.

---

[15] IRS Listing of State and local EITCs https://www.irs.gov/Credits-%26-Deductions/Individuals/Earned-Income-Tax-Credit/States-and-Local-Governments-with-Earned-Income-Tax-Credit.
[16] Revenue and Taxation Code (R&TC) section 17052. For additional information on the California EITC go to www.ftb.ca.gov.
[17] The earned income limits will 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 under R&TC section 17041(h).
[18] http://www.lao.ca.gov/reports/2014/finance/state-eitc/options-state-eitc-121814.pdf, page 26.

Survey of Other States

To explore methods of implementing an EITC that includes SE income, the department surveyed other states through the Federation of Tax Administrators (FTA). Twenty-seven participants representing eighteen (18) states, including eleven (11) that offer an EITC, responded.[19]

Survey Results

The survey results provided limited information on effective methods to verify SE income. An analysis of survey responses indicates the following:

- Approximately one-half of the participants indicated that their state's website provides EITC information. However, only New York's website included specific guidance on recordkeeping suggestions for SE persons claiming the EITC.[20]
- Participants from three states indicated that their state uses IRS Form 8867 *Paid Preparer's Earned Income Checklist*; however, only one state requires the form to be attached to the state tax return. States that do not use the IRS form also reported that they have yet to develop their own due diligence form.
- Participants from five states with an EITC verify SE income even though their state's EITC is a percentage of the federal EITC.[21] Participants identified the following methods used to verify SE income:
  - Match against federal return information.
  - Request documentation from the taxpayer in a pre-refund letter to verify income and expenses, including customer logs and deposits.
  - Apply fraud review techniques based on return characteristics, including refund to income thresholds, suspicious IPs or suspicious preparers.
  - Delay issuing the refund to allow time for verification.
- Participants from five states reported that their state takes on average "one to two months" to review and process a questionable EITC refund.[22]
- Participants representing three states indicated that their state tracks the reasons for improper EITC claims. "Income from self-employment" was identified as the issue that resulted in the highest error rate.[23]

After completion of the survey, representatives from four states reported to FTA that their states are seeing EITC claims for refunds based on Schedule C business income where the business lacks any type of professional business license. Pre-refund letters are sent requesting substantiation of income and expenses. If the business fails to provide the requested information, the claim is denied.

[19] Although the survey results provide information on other state EITCs, the results do not reflect statistically relevant data.
[20] Refer to New York Form DTF-215 at https://www.tax.ny.gov/pit/credits/dtf_215_eitc.pdf.
[21] Seven participants with a state EITC responded; of those responding five indicated their state verifies SE income.
[22] Eight participants responded; and of those, five indicated "one to two months."
[23] Only participants from three states indicated that their state tracks reasons for improper payments. Of those, two states identified "Income from self-employment" as the issue that resulted in the highest error rate.

A representative from one state reported to FTA that analysis of business income-only taxpayers who responded to an EITC request for information showed the following:

- 95 percent of such businesses failed to register.
- It was difficult to differentiate between a legitimate, unregistered, cash-only business and a non-existent business.
- Business income-only EITC claims have one of the state's lowest approval rates.

Summary of Methods Identified to Expand the EITC to Self-employed Individuals:

Based on IRS experience with the federal EITC, expansion of the California EITC from a wage-based credit that enables verification against reliable employer-reported data to a credit that also includes SE income is likely to increase the amount of improper payments. Although Form 1099 or Form 1099-MISC *Miscellaneous Income* (Information Return) would be an indication of authentic business activity, historical return data indicates that only 34 percent of returns at the AGI levels applicable for the California EITC received a Form 1099 or Form 1099-MISC. Based on review of other states' review processes, the most reliable method to minimize improper payments would require significant manual review of EITC claims during return processing prior to the issuance of the refund. Thus, expanding the California EITC to include SE income would be challenging to administer, and the department anticipates the costs to effectively administer the program would be significant.

The following summarizes methods that could be utilized to protect against improper payments if the California EITC was expanded to allow SE income to be included as "earned income."

- Require the trade or business that is the source of SE income to be in existence and have filed income tax returns under Part 10.2 (commencing with section 18401) of Division 2 of the Revenue and Taxation Code for the two taxable years preceding the taxable year for which the taxpayer is claiming the California EITC (under section 17052), or
- Require the trade or business that is the source of SE income to have governmental documentation, such as a city business/tax license, occupational license, or other government issued documentation/identification that supports an active, legitimate trade or business.
- Require that the tax imposed by Section 1401 of the Internal Revenue Code (relating to self-employment tax) has been paid on the net-earnings included in "earned income" for purposes of the California EITC.
- Require the taxpayer that claims the California EITC based on SE income to use electronic technology (e-filed return).

Tax Forms:

- Expand FTB Form 3514 *California Earned Income Tax Credit* to:
    - Request relevant SE income information, including the amount of SE tax paid two taxable years preceding the taxable year the taxpayer is claiming the California EITC; and
    - Provide notification to taxpayers that they could be required to verify the accuracy of the Schedule C for purposes of claiming the California EITC that may include license requirements, records maintained, and income reports.

- Expand FTB Form 3596 *Paid Preparer's California EITC Checklist* to incorporate relevant questions on SE income based on IRS Form 8867.

- Modify FTB Form 4502 (pre-refund request for information from the taxpayer) to request documentation of SE income and expenses.

Return Processing:

- Expand return analysis, including predictive models and business rules to process returns and protect against improper payments related to California EITC claims based on SE income.
- Use FTB historical return data, governmental data, and IRS resources as a means of selecting California EITC claims that require additional verification.
- Manually verify all questionable California EITC claims based on SE income prior to issuing refund.
- Delay issuance of refund for questionable California EITC claims based on SE income until pre-refund verification is complete.
- No interest on refunds held due to questionable California EITC claim.
- Ensure appropriate levels of funding to allow FTB to timely process returns and address improper payments.

Education, Outreach & Website Updates:

- Expand education and outreach efforts including developing webinars and other training materials to educate taxpayers and preparers on common errors related to SE income.
- Update relevant California EITC Web Support with SE income information, including:
    - CalEITC4me.org – This non-government website developed and supported by Dewey Square provides an interactive credit calculator to estimate the state and federal benefit amounts.
    - www.ftb.ca.gov – Update Cal EITC webpage to include SE information for EITC.
- Increase Taxpayer Service Center staff and the Voluntary Income Assistance program (VITA) presence due to increased complexity of claiming California EITC based on SE income.

A detailed discussion of the methods explored is included in the Appendix.

Economic Impact:

Revenue Estimate:

For the 2016 tax year, the expansion of the California EITC to include SE income is estimated to result in approximately 130,000 additional returns and an estimated revenue loss of $70 million.

Appendix

Methods explored to allow self-employment income while protecting against improper payments:

<table>
<tr><th>Requirement</th><th>Discussion of Methods</th><th>Indicates Business</th><th>Valid for Verification of Income[24]</th></tr>
<tr><td>Verification of Net-earnings from Self-Employment:</td><td></td><td></td><td></td></tr>
<tr><td>Use 1099s</td><td>A 1099, including Form 1099-MISC, Miscellaneous Income (Information Return), is generally required if a trade or business made payments of $600 or more. An individual not engaged in a trade or business is not required to provide a 1099. https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Am-I-Required-to-File-a-Form-1099-or-Other-Information-Return
Limitations:
Self-employed (SE) individuals only receive 1099's when they perform services for a trade or business; therefore, 1099's would only report a portion of a SE individual's gross income (Individuals are not required to issue 1099s).
Since 1099's are only prepared for amounts over $600; the 1099s received may not include all of the SE individual's self-employment services to trades or businesses.
1099s would not provide the "net income" amount (gross income less expenses).
Although an indication of authenticate business, return data for 2012 and 2013 shows only 34 percent of Schedule C filers had a 1099.
FTB would not be able to rely on this information to fully validate credit. Manual validation would need to be deployed.</td><td>Yes</td><td>No</td></tr>
<tr><td>Net-earnings Reported on Schedule SE Self-Employment Tax</td><td>Schedule SE would show net-earnings subject to SE tax.
Return data for 2012 and 2013 show that 92 percent of returns with a Schedule C also filed a Schedule SE. https://www.irs.gov/pub/irs-pdf/f1040sse.pdf.
Limitations:
Timeliness/availability of current year IRS SE data would hinder use of SE info. IRS data is unavailable at time return is processed.
Methods considered to resolve timeliness issue:
Use net income reported on Schedule SE from the previous taxable year as the amount of SE income eligible to be included in earned income for the taxable year the credit is claimed, provided the SE tax has been paid. This option may add confusion and complexity to use multiple-year data in the California EITC computation. Additionally, SE tax paid from year to year could vary.
Require taxpayer to enter on FTB Form 3514 the amount of SE tax</td><td>Yes</td><td>No</td></tr>
</table>

[24] Can method be a valid means to compute "net-income" from SE during return processing?

	paid two taxable years prior to the taxable year of the EITC claim. FTB would not be able to rely on this information to fully validate credit. Manual validation would need to be deployed.		

Data Exchange with Welfare Agencies on Income Reported by Benefit Recipients	Current law provides for an exchange of information between FTB and the State Department of Social Services and the Department of Health Care Services (Medi-Cal program) related to applicants for or recipients of public social services programs. (R&TC section 19555) http://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?sectionNum=19555.&lawCode=RTC
	• Request that agencies also provide to FTB the information the applicant/recipient provided on the amount and types of income earned.
	• Limitations:
	    ○ Although California EITC income levels are low (<$13,870), not all taxpayers eligible for EITC may be DSS/DHCS benefit recipients.
	    ○ Gaps in data and reporting would make data unreliable as a means of verifying taxpayer Schedule C income.
	
	FTB would not be able to rely on this information to fully validate credit. Manual validation would need to be deployed.
		N/A	No

Pre-Refund Letter to Taxpayer	Based on income/expense thresholds and other return characteristics, identify claims that should be verified by sending pre-refund letter to taxpayer requesting documentation. A pre-refund letter will extend processing time in excess of 60 days.
	• The quality/type of business records/logs/receipts maintained by taxpayer could authenticate business activity and amount of expenses.
	• Responses from surveys of other states (through FTA) showed that other states send pre-refund letters to taxpayers requesting documentation.
	• IRS sends inquiries to taxpayers including:
	    ○ Form 11652 *Questionnaire and Supporting Documentation Form 1040 Schedule C (Profit and Loss from Business)*
	    ○ IRS Letter 5621 (12-2015) asking taxpayer to self-review EITC claim based on SE income.
		Yes	Yes

Other Options for Expanding EITC to Self-Employed	For ease of administration, compute the California EITC as a percentage of the federal EITC amount (that includes SE income in "earned income"). Current California EITC is not based on a percentage of the federal EITC amount since the California EITC limits "earned income" to wages. • Limitation: Could not use California-only limits on Schedule C businesses (in operation for 2 years, governmental authorization, etc.) if use percentage of federal EITC.	N/A	No
Authentication of Business Activity			
City Business License (CBL) R&TC section 19551.5	CBL would be strong indication of authentic business activity. • Limitations: ○ CBL data available to FTB shows that less than ten percent of Schedule C filers within the California EITC income levels had a CBL.	Yes	N/A

	○ Gaps in data could be attributable to: gaps in city reporting, data errors, taxpayer compliance, whether taxpayer's activity requires CBL. Some small cities/counties may lack the IT infrastructure to submit data in usable format. ○ Provision will be repealed January 1, 2019. Due to gaps in data would need to allow taxpayers to authenticate business by means other than CBL. FTB would not be able to rely on this information to fully validate credit. Manual validation would need to be deployed.		
Occupational License (OL) R&TC section 19528	OL would be strong indication of authentic business activity. • Limitations: ○ OL data available to FTB show that 12 percent of Schedule C filers within the California EITC income levels have an OL (percentage increases to 13 percent when income level is raised to federal EITC level of $53,257). ○ Not all business activities require an OL. Due to low percentage of Schedule C filers with an OL would need to allow taxpayers to authenticate business by means other than OL. FTB would not be able to rely on this information to fully validate credit. Manual validation would need to be deployed.	Yes	N/A
Require Taxpayers Without an OL or CBL to Show Other Governmental Documentation	Other governmental documentation, such as a seller's permit, would indicate authentic business activity. Absent official documentation, a taxpayer's history of filing Schedule C in prior years could be an indication of a legitimate business rather than a fictitious Schedule C. FTB would not be able to rely on this information to fully validate credit. Manual validation would need to be deployed.	Yes	N/A
Filing Requirements for California EITC Claim Based on SE			
Require any EITC based on SE income to be e-filed.	• For the 2014 tax year, 84% percent of all personal income tax (PIT) returns were electronically filed (e-filed). • IRS data shows that for the same filing season, 87 percent of returns were e-filed. https://www.treasury.gov/tigta/auditreports/2015reports/201540080fr.pdf • For the 2015 tax year, 96% of returns claiming the California EITC have been e-filed (based on returns filed through March, 2016). • Numerous benefits to e-filed returns for ease of administration and for taxpayer: ○ E-filed returns are math verified. ○ Assists department with fraud detection. ○ Reduces taxpayer burden. ○ Reduces likelihood of taxpayer being contacted for verification of claim. ○ Taxpayers receive refund sooner.	N/A	Yes
Expand Form	• Add questions from the paid preparer's checklist related to self-employment income or use questions from IRS Form 11652. (Federal	N/A	Yes

FTB 3514	Senate Appropriations Committee report suggested IRS Schedule EIC be revised to include questions from the paid preparer's checklist). http://www.cbpp.org/blog/senate-bill-would-boost-burdens-costs-to-claim-working-family-tax-credits • Require answers to these questions for e-filed return submissions to be accepted and disallow the credit on paper return if required information is not included on form.		
Expand Form FTB 3596	• Add questions from federal paid preparer's checklist related to self-employment income.	N/A	Yes
Enhance Return Analysis (RA) for EITC based on SE			
Manual Review of Suspicious California EITC Claims Based on SE Income Fallout for Review Prior to Issuing Refund	• Survey of other states indicates pre-refund verification of suspicious EITC claims is necessary.	Yes	Yes
Other Policy Considerations			
Limit to Low-Income Taxpayers	To ensure that the California EITC helps the poorest working families, place limitation on Schedule C gross receipts and/or gross assets.	N/A	N/A