Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Steinorth	Analyst:	Davi Milam	Bill Number:	AB 2807
Related Bills:	See Legislative History	Telephone:	845-2551	Amended Date	May 2, 2016
		Attorney:	Bruce Langston	Sponsor:	

SUBJECT: Earned Income Refundable Credit/ Expand to Self-Employed

SUMMARY

The bill would modify the California Earned Income Tax Credit (California EITC).

RECOMMENDATION

No position.

Summary of Amendments

The May 2, 2016, amendments changed the author, removed provisions of the bill related to the minimum franchise tax, and replaced them with the provisions discussed in this analysis.

The department's analysis of the bill as amended March 28, 2016, no longer applies.

REASON FOR THE BILL

The reason for the bill is to expand the California EITC to allow some self-employed individuals to claim the credit.

EFFECTIVE/OPERATIVE DATE

This bill would be effective January 1, 2017, and specifically operative for taxable years beginning on or after January 1, 2016.

FEDERAL/STATE LAW

Federal Law

Existing federal law (Internal Revenue Code (IRC) section 32) allows eligible individuals a refundable Earned Income Tax Credit (EITC). A refundable credit allows for the excess of the credit over the taxpayer's tax liability to be refunded to the taxpayer. The EITC is a percentage of the taxpayer's earned income and is phased out as income increases. The federal credit rate varies from 7.65 percent to 45 percent, depending on the number of qualifying children.[1]

[1] For taxable years beginning on or after January 1, 2016, the Protecting Americans from Tax Hikes Act of 2015 (PATH Act) made permanent the 45 percent credit rate for 3 or more qualifying children and the inflation adjustment related to the reduction of the marriage penalty. The enhancements were formerly provided in IRC section 32(b)(3).

Earned income generally includes two categories of income:

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

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

An eligible individual with:	Earned Income Amount (maximum credit fully phased-in)[2]	Completely Phased-Out at:[3]	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[4]	$13,870	$47,747 ($53,267 if married filing jointly)	$6,242

Federal law defines an eligible individual and a qualifying child, and requires that an eligible individual (and spouse, if filing a joint return) and any qualifying child must have a valid social security number (SSN) issued by the Social Security Administration.

Federal law provides additional rules related to filing status, investment income, and restrictions for taxpayers whose federal EITC was denied.

Federal law imposes requirements on paid tax preparers who prepare tax returns claiming the federal EITC.[5]

Federal law generally requires a trade or business that makes payments of $600 or more to another person during the course of the trade or business to file an information return with the Secretary of the Treasury and to furnish a written statement to that person.[6]

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[2] 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.

[3] Under IRC section 32(a)(2)(B), the credit is phased-out based on adjusted gross income (AGI), or, if greater, the earned income.

[4] For taxable years beginning on or after January 1, 2016, the PATH Act made permanent the EITC enhancements for 3 or more qualifying children and the inflation adjustment related to the reduction of the marriage penalty. The enhancements were formerly provided in IRC section 32(b) (3).

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

[6] Refer to Internal Revenue Code sections 6041 and 6041A.

State Law

State law, beginning with the 2015 taxable year, allows a refundable California EITC in an amount equal to an amount determined in accordance with IRC section 32 as applicable for federal income tax purposes for the taxable year, except as modified.[7]

For 2015, the California EITC is available to households with AGI of:

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

For purposes of the California EITC, the federal definition of “earned income” is modified to include wages, salaries, tips, and other employee compensation, includable in federal AGI, but only if such amounts are subject to California withholding.[8] Additionally, earned income specifically excludes income from SE.

For the 2015 tax year, the state credit percentages match the federal credit percentages (7.65 percent to 45 percent).[9] The maximum California EITC ranges from $214 to $2,653 depending on the number of qualifying children.

The maximum amount of investment income a taxpayer could have and still remain eligible for the credit is $3,400 in 2015. State law generally conforms to the types of disqualified investment income specified under federal law.

State law generally conforms to the federal definitions of an “eligible individual” and a “qualifying child” with the following exceptions:

- An eligible individual without a qualifying child must 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 must have a principal place of abode in “this state” (rather than the United States) for more than one-half of the taxable year.

State law generally conforms to the federal information return requirements for payments totaling $600 or more to any one person made by a trade or business.

[7] The California EITC under Revenue and Taxation Code section 17052 is only 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 legislature also must establish the EITC adjustment factor for each taxable year. Additional modifications apply.

[8] Pursuant to Division 6 (commencing with section 13000) of the Unemployment Insurance Code.

[9] The California EITC, unlike the federal EITC, phases out at the same rate it phases in.

THIS BILL

For taxable years beginning on or after January 1, 2016, this bill would, under the Personal Income Tax Law, modify the California EITC by including, in the definition of earned income, the amount of the taxpayer's "reportable gross income from self-employment" for the taxable year.

"Reportable gross income from self-employment" would mean gross income derived by an individual from any trade or business carried on by such individual that is properly reported to the Secretary of Treasury on an information return for the taxable year and reported on a written statement furnished to that individual as required under federal law.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would require some changes to existing tax forms and instructions and information systems.

LEGISLATIVE HISTORY

SB 80 (Committee on Budget and Fiscal Review, Chapter 21, Statutes of 2015) enacted the California EITC.

PROGRAM BACKGROUND

Franchise Tax Board (FTB) Report

On April 27, 2016, as required by the Supplemental Report of the 2015-16 Budget Package, the FTB issued the report, "Expansion of the California EITC to Include Self-employment Income." The report discusses EITC improper claims and provides a summary of the methods that could be considered to allow SE income to be included as earned income while protecting against improper payments.[10]

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 a 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.

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[10] https://www.ftb.ca.gov/aboutftb/EITCReportToBudgetCommittee.pdf

Massachusetts allows taxpayers to claim a refundable credit equal to 15 percent of their federal EITC. For 2016, the credit will increase to 23 percent.

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

The department's costs to implement this bill have yet to be determined. As the bill moves through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue loss:

Estimated Revenue Impact of AB 2807 As Amended May 2, 2016 Assumed Enactment After June 30, 2016 ($ in Millions)		
2016-17	2017-18	2018-19
- $9.4	- $9.8	- $10

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

Revenue Discussion

Utilizing 2013 tax return data, California EITC eligibility and amounts are calculated based on filing status, income, and number of dependents claimed. The EITC estimate is based on current law parameters for phase-in, phase-outs, earned income, investment income, and federal AGI which were adjusted back to 2013 for changes in the CPI. The estimate applies the current federal EITC credit percentages ranging from 7.65 percent to 45 percent. Taxpayer EITC eligibility and amounts were calculated twice, once applying current law and a second including gross income from self-employment, as reported on information returns, in earned income. The difference between the results represents the impact of the proposed EITC expansion. The results were then grown to 2016 based on Department of Finance forecasted growth rates. The 2016 estimated revenue loss from the expansion of the California EITC to include reported earnings from self-employment is estimated to be $9.4 million.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some may say that expanding the California EITC to include only net earnings from SE reported on a federal 1099 information return would increase taxpayer compliance.

Opponents: Some may argue that this bill would exclude self-employed individuals from receiving the California EITC simply because they did not receive a federal 1099 information return.

LEGISLATIVE STAFF CONTACT

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