Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Stone, et al	Analyst:	Davi Milam	Bill Number:	AB 43
Related Bills:	See Legislative History	Telephone:	845-2551	Amended Dates:	May 20, 2015 & June 01, 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 second refundable EITC equal to an unspecified percentage of the federal EITC.

RECOMMENDATION

No position.

Summary of Amendments

The May 20, 2015, amendments added coauthors and a sunset date. The June 1, 2015, amendments removed the credit percentages and the tax levy language and made other technical changes.

This analysis replaces the department's analysis of this bill as amended February 4 and 12, 2015.

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, 2021.

FEDERAL/STATE LAW

Federal Law

Existing federal law (Internal Revenue Code (IRC) section 32) 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 EITC is a percentage of the taxpayer's earned income and is phased-out as income increases.

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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 EITC 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 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

[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 adjusted each taxable year by the cost-of-living adjustment.

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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[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 under IRC section 911, and most nonresident aliens, unless they elect to be treated as US residents for federal tax purposes.

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

Existing state law, for taxable years beginning on or after January 1, 2015, provides a refundable CA 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 discussed below.

The amount of the credit is multiplied by the EITC adjustment factor for the taxable year. Unless otherwise specified in the annual Budget Act, the EITC adjustment factor is zero percent. (For taxable year 2015, the EITC adjustment factor specified in the Budget Act was 85 percent).[11]

The CA EITC is only operative for taxable years for which resources are authorized in the annual Budget Act for the Franchise Tax Board (FTB) to oversee and audit returns associated with the credit. The Budget Act of 2015 (AB 93) provided an appropriation for the FTB related to the EITC.

The state credit percentages match the federal credit percentages (7.65 percent to 45 percent), but the state phaseout percentages differ from the federal percentages as shown in the table below:

In the case of an eligible individual with:	The credit percentage is:[12]	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	45%	45%

[10] Treas. Reg. section 1.6695–2, Tax return preparer due diligence requirements for determining earned income credit eligibility.
[11] Based on the Budget Act of 2015 (AB 93).
[12] Percentages agree with the federal credit percentages.

For purposes of computing the CA EITC, the following earned income and phaseout amounts apply in lieu of the federal amounts.[13] For the 2015 taxable year, the maximum CA EITC (after applying the 85 percent EITC adjustment factor) ranges from $214 for an eligible individual without a qualifying child to $2,653 for an eligible individual with three or more qualifying children.

In the case of an eligible individual with:	Earned Income Amount (maximum credit fully phased-in)[14]	The Phaseout Amount:	Completely Phased-out at:[15]	Maximum CA EITC (before EITC adjustment factor)	Maximum CA EITC (with 85% EITC adjustment factor)[16]
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	$2,653

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 under federal law.

The earned income, phaseout, and investment income amounts 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.[17]

State law 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.

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[13] Prescribed in IRC section 32(b)(2)(A).
[14] This is the earned income level at which the maximum CA EITC is received. Unlike the federal credit, the state credit immediately begins to phaseout at income above this level.
[15] For the 2015 taxable year, the CA EITC is completely phased-out at the income level at which the maximum federal EITC is fully phased-in. Refer to Table in *Federal Law*, page 2, column 2.
[16] The EITC adjustment factor of 85% is provided in the Budget Act of 2015 (AB 93). Credit amounts shown in the above table are rounded to the nearest one dollar.
[17] Under R&TC section 17041(h).

For purposes of the CA EITC, the definition of "earned income" is modified to include wages, salaries, tips, and other employee compensation, but only if such amounts are subject to California withholding.[18] Additionally, earned income specifically excludes income from self-employment.

State law generally conforms to the types of income excludable as earned income for purposes of computing the EITC.

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

The FTB may prescribe rules, guidelines, or procedures necessary or appropriate to carry out the purposes of this section. The rules, guidelines or procedures are exempt from the Administrative Procedure Act.

The FTB must annually report to the Legislature on specified information related to the CA EITC.

Current state law provides the following:

- 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 applies to penalties imposed on or after January 1, 2016.
- Conformity to the $500 penalty for paid preparers who fail to comply with the due diligence requirements for determining eligibility for EITC.

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.

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, 2016, and before January 1, 2021, this bill would provide a refundable state EITC equal to unspecified percentages of the federal EITC.[19]

[18] Pursuant to Division 6 (commencing with section 13000) of the Unemployment Insurance Code.
[19] IRC section 32. The most recent change to the federal EITC was made on December 19, 2014, by Section 206(a) of Public Law 113-295.

The credit percentages would be “set forth in a bill related to the budget” and would vary based on three categories of eligible individuals,[20] as follows:

- An eligible individual who has at least one qualifying child under five years of age;
- An eligible individual who does not have a qualifying child; or
- Any other eligible individual who does not meet the above two requirements.

This bill would provide the following:

- 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 to the qualified taxpayer.
- Any amounts refunded to a taxpayer would not be included in income.
- The credit would only be allowed in taxable years in which the Legislature provides for it in a bill related to the budget.

This bill would be repealed on December 1, 2021.

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.

Absent credit percentages for the computation of the credit, the department would be unable to implement the bill or develop an economic impact.

This credit would “only be allowed in taxable years in which the Legislature provides for it in a bill related to the budget.” It is unclear what is meant by the phrase, “set forth in a bill related to the budget.” If the author’s intent is for the credit to be provided for in a bill related to the annual Budget Act, this bill should be amended.

Current state law provides a CA EITC for taxable years beginning on or after January 1, 2015. This bill would provide a second EITC for taxable years beginning on or after January 1, 2016. Both credits would be operative starting with the 2016 taxable year. If this is inconsistent with the author’s intent, the bill should be amended.

[20] Under IRC section 32(c)(1) an “eligible individual,” generally, must meet earned income, adjusted gross income (AGI), and investment income requirements as well as filing requirements if claiming an increased credit amount for having a qualifying child (children).

The taxpayer error rate on the federal EITC causes the IRS[21] 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. 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.

TECHNICAL CONSIDERATIONS

This bill provides that the state EITC would be determined in accordance with IRC section 32 as amended by a number of specific public laws, relating to EITC, as modified, which could be overly confusing. To avoid potential confusion among taxpayers on which version of the Federal EITC applies to the state credit, it is recommended that the bill be amended.

LEGISLATIVE HISTORY

SB 80 (Committee on Budget and Fiscal Review, Chapter 21, Statutes of 2015), created a refundable CA EITC for taxable years beginning on or after January 1, 2015.

AB 107 (Assembly Committee on Budget, 2015/2016), would create a refundable EITC identical to the credit enacted by SB 80. AB 107 is pending before the Senate.

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[21] Treasury Inspector General (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. http://www.treasury.gov/tigta/auditreports/2014reports/201440093fr.pdf.

SB 38 (Liu, 2015/2016), would create a refundable EITC identical the EITC enacted by SB 80. SB 38 is pending before the Assembly Revenue and Taxation Committee.

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

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 (GAO) 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 (OMB). 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]

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[22] 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.
[23] U.S. GAO Report 15-482T *Improper Payments.* http://www.gao.gov/assets/670/669026.pdf.

[24] 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.

Legislative Analyst Office (LAO) Report

On December 18, 2014, 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 also discussed 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 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.

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

Department staff is unable to determine the costs to administer this bill. As implementation considerations are resolved, costs will be identified and an appropriation will be requested, if necessary. Because this bill would provide a refundable credit on a year-to-year basis, and could impact over three million California taxpayers who claimed the federal EITC, many of which have no current California income tax return filing requirement, the costs are anticipated to be significant.

The state's first CA EITC, enacted by SB 80, was estimated to impact less than one million individuals. Fiscal costs to administer SB 80 ranged from approximately $22 million for fiscal year 2015/2016, $11.6 million for fiscal year 2016/2017, to ongoing costs of $10.1 million beginning with fiscal year 2017/2018.

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

ECONOMIC IMPACT

Revenue Estimate:

The department is unable to determine the revenue impact of this bill as amended June 1, 2015, because the credit percentages needed to do the calculation were not provided.

Revenue Discussion:

Approximately $7.5 billion in federal EITC was claimed by 3.2 million California taxpayers in the 2012 taxable year. Without the credit percentages the FTB cannot estimate the amount of California EITC that would be generated. However, should 100 percent of the federal credit be allowed, the revenue loss would be approximately $7.5 billion per year.

SUPPORT/OPPOSITION[26]

Support: United Way of California (Sponsor), Alameda County Board of Supervisors (Co-Sponsor), Allen Temple Baptist Church, Alliance for African Assistance, American Federation of State, County and Municipal Employees, Amigos de Guadalupe Center for Justice & Empowerment, Arrowhead United Way, Asian Americans Advancing Justice, Brighter Beginnings, California Alternative Payment Program Association, California Association of Food Banks, California Association of Nonprofits, California Catholic Conference of Bishops, California Communities United Institute, California Food Policy Advocates, California Partnership, California Reinvestment Coalition, California Tax Reform Association, Catholic Charities of Santa Clara County, Children's Defense Fund, Children's Partnership, Community Child Care Council of Alameda County, Consumer Action, Contra Costa AFL-CIO Labor Council, Contra Costa County Board of Supervisors, Contra Costa's Family Economic Security Partnership, Cooperative Center Federal Credit Union, Council of California Goodwill, Industries, Council of Philippine American Organizations of San Diego, County of Santa Cruz Board of Supervisors, EARN, FIRST 5 of Monterey County, FIRST 5 of Santa Clara County, Housing California, Jewish Family Services of Silicon Valley, Jewish Federation of Silicon Valley, Law Foundation of Silicon Valley, Legal Aid Association of California, Monterey County Board of Supervisors, National Association of Social Workers, Northeast Community Federal Credit Union, Older Women's League Sacramento Capitol, Policy Link, Puente, Samaritan House, San Francisco Community Empowerment Center, San Jose Silicon Valley Chamber of Commerce, San Mateo County Central Labor Council, San Cruz County Children's Network, Santa Clara County Board of Supervisors, Solano Children's Alliance, Somos Mayfair, St. Joseph's Family Center, Step Up Silicon Valley, United Way of Fresno County, United Way of Monterey County, United Way of Orange County, United Way of San Diego County, United Way of Santa Barbara County, United Way of Bay Area, United Way of Santa Cruz County, United Way of Silicon Valley, United Way of Stanislaus County, United Way of Wine Country, Western Center on Law & Poverty, Women's Building, and One Individual.

Opposition: California Taxpayers Association.

[26] As noted in the Assembly Revenue and Taxation Committee analysis dated May 15, 2015.

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

California recently enacted a refundable EITC for taxable years beginning on or after January 1, 2015. This bill would create a second refundable EITC for taxable years beginning on or after January 1, 2016, and before January 1, 2021. Consequently, this bill could allow taxpayers in certain circumstances to claim multiple tax benefits by claiming both credits.

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