

ANALYSIS OF AMENDED BILL

Author: Ting Analyst: Davi Milam Bill Number: AB 1010
Related Bills: See Legislative History Telephone: 845-2551 Amended Date: March 21, 2017
Attorney: Bruce Langston Sponsor: _____

SUBJECT: Earned Income Refundable Tax Credit/ Expand to Self-Employed & Change Phaseout Percentage

SUMMARY

This bill would, under the Personal Income Tax Law (PITL), modify the California Earned Income Tax Credit (California EITC).

RECOMMENDATION – NO POSITION**Summary of Amendments**

The March 21, 2017, amendments removed provisions of the bill that made nonsubstantive changes to the PITL related to items specifically excluded from gross income, and replaced them with the provisions discussed in this analysis.

This is the department's first analysis of the bill.

REASON FOR THE BILL

The reason for the bill is to allow more low- to moderate-income Californians, including self-employed individuals, to qualify for the California EITC.

EFFECTIVE/OPERATIVE DATE

This bill would be effective January 1, 2018, and specifically operative for taxable years beginning on and after January 1, 2017.

FEDERAL/STATE 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.

Earned income generally includes two categories of income:¹

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

¹ IRC section 32(c) (2) (A).

The EITC percentage varies, based on whether the taxpayer has qualifying children. The federal credit rate for the 2016 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%	21.06%

The 2016 earned income amounts at which the EITC is completely phased-out and the maximum credit amounts are shown below:

An eligible individual with:	Completely Phased-Out at: ²	2016 Max. Credit
No qualifying children	\$14,880 (\$20,430 if married filing jointly)	\$506
1 qualifying child	\$39,296 (\$44,846 if married filing jointly)	\$3,373
2 qualifying children	\$44,648 (\$50,198 if married filing jointly)	\$5,572
3 or more qualifying children	\$47,955 (\$53,505 if married filing jointly)	\$6,269

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 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, in whole or in part, in prior years.

Federal law imposes requirements on paid tax preparers who prepare tax returns claiming the federal EITC.³

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

³ Treas. Reg. section 1.6695-2, Tax return preparer due diligence requirements for determining earned income credit eligibility.

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.⁴

For purposes of the California 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.⁵ Additionally, earned income specifically excludes income from self-employment.

The state credit percentages match the federal credit percentages, but the California EITC phases out at different percentages as shown in the table below:

In the case of an eligible individual with:	The credit percentage would be: ⁶	The phaseout percentage would be:
No qualifying children	7.65%	7.65%
1 qualifying child	34%	34%
2 qualifying children	40%	40%
3 or more qualifying children	45%	45%

For purposes of computing the California EITC, the following earned income and phaseout table is used in lieu of the federal table:

In the case of an eligible individual with:	Earned Income Amount (maximum credit fully phased-in) ¹	The Phaseout Amount:
No qualifying children	\$3,290	\$3,290
1 qualifying child	\$4,940	\$4,940
2 or more qualifying children	\$6,935	\$6,935

The earned income and phaseout amounts are adjusted annually for inflation in the same manner as the recomputation of the state income tax brackets.⁷

⁴ The California 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 Legislature also must establish the California EITC adjustment factor for each taxable year; otherwise the California EITC adjustment factor is zero. For 2016, the California EITC adjustment factor is 85 percent. The Budget Act of 2017 (AB 96, Ting, 2017/2018) would provide a California EITC adjustment factor of 85 percent for tax year 2017.

⁵ Pursuant to Division 6 (commencing with section 13000) of the Unemployment Insurance Code.

⁶ Percentages agree with the federal credit percentages.

⁷ The California Consumer Price Index (CCPI) is used to adjust the state income tax brackets and is available in August of each year.

For 2016, the California EITC is available to households with AGI of up to:

- \$6,717 if there are no qualifying children,
- \$10,087 if there is one qualifying child, or
- \$14,161 if there are two or more qualifying children.

For the 2016 tax year, the maximum California EITC ranges from \$217 to \$2,706 depending on the number of qualifying children.

The maximum adjusted amount of investment income a taxpayer could have and still remain eligible for the credit is \$3,471 in 2016.⁸ 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.

THIS BILL

For taxable years beginning on and after January 1, 2017, this bill would modify the California EITC phaseout percentages as shown in the table below:

In the case of an eligible individual with:	The phaseout percentage under current law:	The phaseout percentage under the terms of this bill:
No qualifying children	7.65%	2.22%
1 qualifying child	34%	4.99%
2 qualifying children	40%	7.53%
3 or more qualifying children	45%	7.79%

For 2017, under the terms of this bill, the maximum California AGI amounts are estimated to be:⁹

- \$15,200 if there are no qualifying children,
- \$40,300 if there is one qualifying child,

⁸ The investment income cap also is adjusted annually for inflation based on the change in the CCPI.

⁹ The above 2017 maximum AGI amounts have been estimated by applying the Department of Finance’s estimated three percent growth rate to the 2016 amounts. The actual CCPI will be available in August of 2017. Should there be a difference between the estimated and actual growth rates, the actual AGI amounts will differ from the estimated amounts shown above.

- \$45,700 if there are two qualifying children, or
- \$49,050 if there are three or more qualifying children.

This bill would also modify the California EITC by including, in the definition of earned income, net earnings from self-employment, consistent with federal law.

PROGRAM BACKGROUND

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 self-employment income to be included as earned income while protecting against improper payments.¹⁰

IMPLEMENTATION CONSIDERATIONS

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

LEGISLATIVE HISTORY

AB 75 (Steinorth, 2017/2018) would expand the California EITC earned income to include "reportable gross income from self-employment," and permanently set the California EITC adjustment factor at 85 percent rather than zero. AB 75 is pending before the Assembly Revenue and Taxation Committee.

AB 225 (Caballero, 2017/2018) would expand the maximum AGI thresholds for the California EITC. AB 225 is pending before the Assembly Appropriations Committee.

AB 2807 (Steinorth, 2015/2016) would have, similar to AB 75, expanded the California EITC earned income to include "reportable gross income from self-employment." AB 2807 failed to pass by the constitutional deadline.

SB 1073 (Monning, Chapter 722, Statutes of 2016) made permanent the enhanced 45-percent credit rate for three or more qualifying children consistent with federal.

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

¹⁰ <https://www.ftb.ca.gov/aboutftb/EITCReportToBudgetCommittee.pdf>

OTHER STATES' INFORMATION

The states surveyed include *Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy and tax laws.

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 23 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 refundable 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, but are anticipated to be significant. 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 1010 As Amended March 21, 2017 Assumed Enactment After June 30, 2017 (\$ in Billions)		
2017-18	2018-19	2019-20
- \$1.7	- \$1.8	- \$1.8

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

Revenue Discussion:

Utilizing 2014 taxable year data from California returns, taxpayer California EITC eligibility and amounts are calculated based on filing status, income, and number of dependents claimed. The estimate of California EITC is based on current law parameters for phase-in, phaseouts, earned income, investment income, and federal AGI, which were adjusted back to 2014 for changes in the CCPI. Taxpayer California EITC eligibility and amounts were calculated twice:

once for current law and a second time that includes net earnings from self-employment as well as the proposed phaseout percentages. The difference in the two calculations is the net impact of the California EITC expansion to include self-employment income and proposed phaseout percentages. The 2017 estimated revenue loss is expected to be \$1.7 billion. Results were then adjusted to reflect changes in the economy over time.

The tax-year estimates are converted to fiscal-year estimates, and then rounded to arrive at the amounts reflected in the above table.

SUPPORT/OPPOSITION¹¹

Support: California Alternative Payment Program Association, California Association of Food Banks, California Association for Micro Enterprise Opportunity, California Catholic Conference, Inc., Children's Defense Fund – California, Common Sense Kids Action, County Welfare Directors Association of California, Friends Committee on Legislation of California, Golden State Opportunity, Small Business California, and one individual.

Opposition: None provided.

ARGUMENTS

Proponents: Some may say that expanding the California EITC to individuals who receive earnings from self-employment would provide financial assistance to low-income working families and stimulate the economy.

Opponents: Some may argue that expanding a tax credit limited to low- to moderate-income families may be overly narrow and inadvertently exclude other Californians that need assistance.

POLICY CONCERNS

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 the IRS has had difficulty verifying self-employment income; this issue could be duplicated for the California EITC.

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¹¹ As noted in the Assembly Revenue and Taxation Committee analysis dated March 24, 2017.