Franchise Tax Board **ANALYSIS OF ORIGINAL BILL**

Author:	Caballero	Analyst:	Davi Milam	Bill Number:	AB 225
Related Bills:	See Legislative History	Telephone:	845-2551	Introduced Date:	January 26, 2017
		Attorney:	Bruce Langston	Sponsor:	

SUBJECT: Earned Income Refundable Credit/Increase Income Thresholds

SUMMARY

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

RECOMMENDATION: NO POSITION

REASON FOR THE BILL

The reason for the bill is to allow more low- to moderate-income Californians 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 or after January 1, 2017.

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.

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:[1]	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

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

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.[2]

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.

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.[3]

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.[4]

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[2] Treas. Reg. section 1.6695–2, Tax return preparer due diligence requirements for determining earned income credit eligibility.
[3] The Budget Act of 2017 (AB 96, Ting, 2017/2018) would provide a California EITC adjustment factor of 85 percent for tax year 2017.
[4] 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 state credit percentages match the federal credit percentages (7.65 percent to 45 percent).[5] 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.[6] 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 or after January 1, 2017, this bill would, under the Personal Income Tax Law, increase the maximum AGI phaseout amounts for the California EITC by replacing the earned income and phaseout amount table with the table shown below.

In the case of an eligible individual with:	Earned Income Amount (maximum credit fully phased-in)	The Phaseout Amount:
No qualifying children	$5,181	$5,181
1 qualifying child	$7,779	$7,779
2 or more qualifying children	$10,920	$10,920

For 2017, the California EITC would, under the terms of this bill, be available to households with AGI of less than:

- $10,362 if there are no qualifying children,[7]
- $15,558 if there is one qualifying child,[8] or
- $21,840 if there are two or more qualifying children.[9]

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[5] The California EITC, unlike the federal EITC, phases out at the same rate it phases in.
[6] The investment income cap also is adjusted annually for inflation based on the change in the CCPI.
[7] The California EITC would phaseout between AGI of $5,181 and $10,362.
[8] The California EITC would phaseout between AGI of $7,779 and $15,558.
[9] The California EITC would phaseout between AGI of $10,920 and $21,840, which is the approximate full-time, minimum wage as of January 1, 2017 ($10.50 per hour at 40 hours per week).

This bill would also:

- Require that the earned income, phaseout, and investment income amounts be adjusted annually for inflation for taxable years beginning on or after January 1, 2018, in the same manner as the recomputation of the state income tax brackets.
- Replace the investment income cap with the estimated adjusted amount for taxable year 2017.

IMPLEMENTATION CONSIDERATIONS

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

TECHNICAL CONSIDERATIONS

To allow for indexing the investment income amount for taxable years beginning on or after January 1, 2018, this bill would make a technical change to the investment income cap by substituting the estimated adjusted amount for 2017. The estimated amount for 2017 was derived by applying the Department of Finance’s estimated three percent growth rate to the 2016 amount ($3,471). Should the estimated and actual CCPI growth rates differ, the author may wish to amend the 2017 estimated cap on investment income to reflect the actual CCPI growth rate when it becomes available in August of 2017.

On page 3, line 26, and on page 4, lines 13 and 14, the phrase “relating to in general,” is unnecessary.

LEGISLATIVE HISTORY

AB 75 (Steinorth, 2017/2018) would expand the California EITC earned income to include “reportable gross income from self-employment.” AB 75 is pending before the Assembly Revenue and Taxation 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.

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, business entity types, 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 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 225 As Introduced January 26, 2017 Assumed Enactment After June 30, 2017 ($ in Millions)		
2017-18	2018-19	2019-20
- $400	- $420	- $430

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 for the proposed law which includes the expansion of California EITC income and phaseout parameters in 2017 as specified in this bill. The 2017 parameters were adjusted back to 2014 for changes in CCPI.

The difference in the two calculations is the net impact of the California EITC income and phaseout expansion. Results were then adjusted to reflect changes in the economy over time. The 2017 revenue loss from the expansion of the California EITC is estimated to be $400 million.

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

SUPPORT/OPPOSITION

Support: State Board of Equalization member Fiona Ma, CPA (sponsor)

Opposition: None provided.

ARGUMENTS

Proponents: Some may say that increasing the AGI limits for the California EITC would provide financial assistance to more working class families in California.

Opponents: Some may argue that this bill is overly narrow and would continue to exclude other California working families that need assistance.

LEGISLATIVE STAFF CONTACT

Davi Milam	Jame Eiserman	Diane Deatherage
Legislative Analyst, FTB	Revenue Manager, FTB	Legislative Director, FTB
(916) 845-2551	(916) 845-7484	(916) 845-6333
davi.milam@ftb.ca.gov	jame.eiserman@ftb.ca.gov	diane.deatherage@ftb.ca.gov