Franchise Tax Board **ANALYSIS OF ORIGINAL BILL**

Author:	Steinorth	Analyst:	Davi Milam	Bill Number:	AB 75
Related Bills:	See Legislative History	Telephone:	845-2551	Introduced Date:	January 04, 2017
		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

REASON FOR THE BILL

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

EFFECTIVE/OPERATIVE DATE

As an urgency measure, this bill would be effective immediately upon enactment, and retroactively operative for taxable years beginning on or after January 1, 2016.

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.

Earned income generally includes two categories of income:

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

The 2016 earned income amounts at which the EITC is completely phased-out 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

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, 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]

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.[3]

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.

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[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.
[2] Treas. Reg. § 1.6695–2, Tax return preparer due diligence requirements for determining earned income credit eligibility.
[3] Refer to IRC sections 6041 and 6041A.

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 adjustment factor is zero. For 2016, the California EITC adjustment factor is 85 percent.[4]

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 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.[5] Additionally, earned income specifically excludes income from SE.

For the 2016 tax year, the state credit percentages match the federal credit percentages (7.65 percent to 45 percent).[6] The maximum California EITC ranges from $217 to $2,706 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 $3,471 in 2016. 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.

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.

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[4] The Budget Act of 2017 would provide an 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] The California EITC, unlike the federal EITC, phases out at the same rate it phases in.

"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.

This bill also would, for taxable years beginning on or after January 1, 2016, permanently set the California EITC adjustment factor at 85 percent rather than zero.

IMPLEMENTATION CONSIDERATIONS

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

The department has already developed the forms and instructions for the 2016 taxable year and taxpayers have begun filing returns for that year. Thus, the department and software vendors would incur additional costs to develop additional tax forms and instructions in the short time frame necessary to ensure they are available for taxpayers. Taxpayers may also file amended returns for the 2016 taxable year. To alleviate these concerns, the author may wish to change the operative date to taxable years beginning on or after January 1, 2017.

LEGISLATIVE HISTORY

AB 2807 (Steinorth, 2015/2016) would have, similar to this bill, expanded the California EITC to apply to "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 law.

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.[7]

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[7] 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, 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 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 75 As Introduced January 4, 2017 Assumed Enactment After June 30, 2017 ($ in Millions)			
2016-17	2017-18	2018-19	2019-20
- $1.1	- $13	- $13	- $13

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, phase-outs, earned income, investment income, and federal AGI which were adjusted back to 2014 for changes in the California Consumer Price Index. Taxpayer California EITC eligibility and amounts were calculated twice: once for current law and a second time that includes "reportable gross income from self-employment" as reported on form 1099-MISC as part of the earned income qualifications. The difference in the two calculations is the net impact of the

California EITC expansion to include income reported on the federal 1099-MISC. The additional qualifying income may increase the California EITC for some taxpayers but for others it may not only decrease the credit amount but disqualify them from taking the credit. Results were then adjusted to reflect changes in the economy over time. The 2017 estimated revenue loss from the expansion of the California EITC to include reportable gross income from SE is expected to be $12 million.

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

The $1.1 million loss in fiscal year 2016-17 represents amended returns for the 2016 taxable year. Due to the retroactive nature of the 2016 operative date, those taxpayers whose increased income reduces or eliminates their credit eligibility would be required to pay back the amount of credit that they are no longer entitled to. The estimate does not take into account the collectability of credit repayments.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Some may say that expanding the California EITC to individuals that receive earnings from SE reported via a federal 1099-MISC information return is a prudent way to expand the credit while minimizing improper claims.

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

POLICY CONCERNS

This bill was introduced in the 2017 legislative session and would modify the California EITC for taxable years beginning on or after January 1, 2016. As a result, this bill would be considered retroactive to the specified operative date of January 1, 2016, and credits claimed by taxpayers based on their SE income could be construed as a gift of public funds.

The IRS has historically experienced a high rate of improper payments related to taxpayers claiming the federal EITC based on SE income. To the extent the IRS has had difficulty verifying SE income; this issue could be duplicated for the California EITC.

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