

BILL ANALYSIS

Department, Board, Or Commission	Author	Bill Number
Franchise Tax Board	Senate Committee on Budget & Fiscal Review	SB 106

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

SUMMARY

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

REASON FOR THE BILL

The reason for the bill is to allow more low-to moderate-income Californians, including those who are self-employed, to claim the California EITC.

EFFECTIVE/OPERATIVE DATE

This bill, providing for appropriations related to the Budget Bill and identified as a bill related to the budget in the Budget Bill, would be effective immediately upon enactment. The modifications to the California EITC would be 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.

Earned income generally includes two categories of income:

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

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

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

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. 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.

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.⁴ Additionally, earned income specifically excludes net earnings from self-employment.

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)	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.⁵

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).⁶ 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 2016.⁷ 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.

⁴ Pursuant to Division 6 (commencing with section 13000) of the Unemployment Insurance Code.

⁵ The California Consumer Price Index (CCPI) is used to adjust the state income tax brackets and is available in August of each year.

⁶ The California EITC, unlike the federal EITC, phases out at the same rate it phases in.

⁷ The investment income cap also is adjusted annually for inflation based on the change in the CCPI.

THIS BILL

For taxable years beginning on or after January 1, 2017, this bill would, under the Personal Income Tax Law, modify the California EITC by including, in the definition of earned income, net earnings from self-employment, consistent with federal law.

This bill also would increase the maximum AGI phaseout amounts for the California EITC by substituting new tables for the credit and phaseout percentages and the earned income and phaseout amounts after the credit amount phases down to \$100⁸ for a taxpayer with no qualifying children or \$250 for a taxpayer with one or more qualifying children.

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

- \$15,010 if there are no qualifying children,⁹
- \$22,301 if there are one or more qualifying children, which is the approximate full-time, state minimum wage as of January 1, 2017).¹⁰

For taxable years beginning on or after January 1, 2018, the above amounts would be annually adjusted in the same manner as the income tax brackets.

In addition, this bill would authorize the FTB to prescribe regulations necessary or appropriate to carry out the purposes of this section, including regulations to prevent improper claims from being filed or improper payments from being made with respect to net earnings from self-employment, and make a legislative finding of a deemed emergency allowing any such regulations to be adopted as emergency regulations. Further, the bill would allow the adoption of any such regulations without review and approval by the Office of Administrative Law, and for such emergency regulations to remain in effect until revised or repealed by the FTB, both as exceptions to the normal rules governing adoption of regulations under the Administrative Procedure Act.

LEGISLATIVE HISTORY

AB 75 (Steinorth, 2017/2018) would expand the California EITC earned income computation 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.

⁸ The \$100 and \$250 credit amounts are determined after applying the EITC adjustment factor.

⁹ The California EITC would phaseout at a decreased rate between AGI of \$5,320 and \$15,010.

¹⁰ The California EITC would phaseout at a decreased rate as follows:

For one qualifying child, between AGI of \$9,434 and \$22,301.

For two qualifying children, between \$13,723 and \$22,301.

For three or more qualifying children between \$13,805 and \$22,301.

AB 121 (Assembly Committee on Budget, 2017/2018), substantially similar to this bill, would expand the California EITC to include in the earned income computation, net earnings from self-employment, and would increase the maximum AGI phaseout amount. AB 121 is pending on the Senate Third Reading File.

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 1010 (Ting, 2017/2018) would expand the California EITC earned income computation to include net earnings from self-employment and would increase the maximum AGI thresholds for the California EITC. AB 1010 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.

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.¹¹

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.

¹¹ <https://www.ftb.ca.gov/aboutftb/EITCReportToBudgetCommittee.pdf>

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 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

Staff estimates a cost of approximately \$9,707,000 for fiscal year 2017/2018, \$9,639,000 for fiscal year 2018/2019, and ongoing costs of \$5,910,000 beginning with fiscal year 2018/2019 for resources to build the necessary system infrastructure, respond to taxpayer and tax preparer questions, provide education and outreach, review returns, and prevent improper refunds from being issued. SB 108 (Senate Committee on Budget and Fiscal Review) would authorize a budget augmentation of up to \$10,000,000 to fund costs incurred by the FTB to implement the California EITC eligibility expansion.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue loss:

Estimated Revenue Impact of SB 106 Assumed Enactment After June 30, 2017 (\$ in Millions)		
2017-18	2018-19	2019-20
- \$140	- \$150	- \$155

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 the 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 consumer price index (CPI). Taxpayer California EITC and amounts were calculated twice: once for current law and a second time for proposed law that includes the expansion of the California EITC income and phaseout parameters and the inclusion of net earnings from self-employment beginning in 2017, as specified in this bill. The 2017 parameters were adjusted back to 2014 for changes in CPI.

The difference in the two calculations is the estimated net impact of the expansion of the California EITC income and phaseout levels and inclusion of net earnings from self-employment. The result was 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 \$140 million. The tax year estimates are converted to fiscal year estimates and then rounded to arrive at the amounts reflected in the above table.

APPOINTMENTS

None.

VOTES

	Date	Yes	No
Concurrence	07/06/17	27	9
Assembly Floor	06/22/17	56	13
Senate Floor	05/11/17 ¹²	26	9

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¹² The May 11, 2017, vote taken on the bill as introduced rather than the bill as amended June 13, 2017.