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State Controller's Message



California has truly entered a golden period of economic prosperity and vitality. This economic boom has resulted in a staggering amount of additional tax revenue, upwards of \$10 billion dollars, filling the state coffers. Against this unusual backdrop, California has been given the opportunity to make profound changes in a number of vital policy arenas that will directly affect its future economic health.

Tax policy is one of those critical elements affecting California's economy. Specifically, the simplification of tax policy has been long-overdue for taxpayers. Furthermore, the recent surge in tax revenues affords California the opportunity to make changes to its tax policy without cutting any programs or services. However, any tax policy changes must take into account four specific tax policy goals: Conformity, Simplicity, Fairness, and Investment.

Conformity between California's tax code and the federal tax code should be instituted as a tax policy in order to increase correct taxpayer compliance and to lower taxpayer actuarial costs. Tax policy simplicity ought to be maximized in order to lower taxpayer dissatisfaction and filing errors. Tax policy should also be constructed with fairness for all taxpayers, so that taxes do not represent an excess financial burden. Finally, tax policy should view some policies as economic investments in California and not solely as forms of revenue generation or loss.

With these four tax goals in mind, I convened a Task Force to consider ways to refresh California's existing tax system in order to maximize California's potential and minimize taxpayer dissatisfaction. The Task Force consisted of notable financial experts with extensive backgrounds in individual, small business, and corporate taxes. I would like to thank them for their dedication to this effort and for their worthy recommendations.

During their meetings, the Task Force surveyed a diverse array of tax issues important to all individuals and businesses in California. Their discussions led to the formulation of policy recommendations that affect every California taxpayer. Those recommendations are separated into the four tax policy goals and include their direct tax savings effect on taxpayers.

The Task Force and I recognize that the Legislature and the Governor cannot enact all of these recommendations without placing an extraordinary burden on state revenues. The recommendations are

offered as potential alternatives, some of which the Legislature may choose to incorporate into this year's budget. Certain conformity recommendations have limited general fund cost, and would significantly simplify our tax system. However, as the state's chief financial officer, I am cognizant of how carefully we must weigh each tax simplification proposal to assure California's fiscal stability in the future.

I hope that the work of this Task Force will spark fruitful discussions on tax reform throughout the state and help fashion tax policy reform that benefits the long-term economic well-being of every Californian.

KATHLEEN CONNELL
California State Controller

Executive Summary

Two themes — conformity and competitiveness — quickly emerged during the Task Force discussions. The group readily agreed that the relationship between all Californians and the taxes they pay to the Franchise Tax Board should be simplified. At the same time, there was a strong sense that California should be made an attractive location for people and businesses to establish themselves and grow.

Conformity. The Task Force recognized that income tax simplification for Californians means, first and foremost, conformity to federal income tax law. Thus, the Task Force squarely identified conformity as the primary goal for California’s income and franchise tax laws.

The Task Force acknowledged the constitutional and practical problems that having automatic conformity or using a percentage of the federal tax (piggybacking) present for California. Also, not every federal tax law provision will have relevance to California’s situation. While elective piggybacking may be an option, the Task Force believes California’s current practice of selective conformity will continue and therefore recommends that the Legislature:

- Draft the Revenue and Taxation Code in a more user-friendly format so that at the very least tax practitioners can readily decipher where conformity starts and where it ends;
- Make conformity with federal law an express policy; and
- Articulate clearly, when choosing not to conform to a particular federal tax law change, a non-revenue reason why California’s tax policy should differ.

The Task Force also identified specific existing non-conformity items for which conformity should be achieved without further delay:

- Phase-out for itemized deductions;
- Depreciation;
- Net operating losses; and
- Charitable contributions of appreciated property.

Simplicity. Achieving conformity will greatly assist in achieving simplicity. The Task Force believes, however, that conformity is only a piece of the simplification puzzle. The Task Force therefore recommends:

- Demonstrating leadership to the federal government by acting to eliminate elements that unnecessarily complicate compliance and burden taxpayers and, in particular, by repealing the alternative minimum tax;
- Eliminating problem elements peculiar to California law to make California's combined report as similar to a federal consolidated return as possible and, in particular, by allowing a full deduction for dividends received by corporations and allowing the use of credits on a unitary group basis;
- Treating all pass-through business entities equally by repealing the differing fees and imposing only an annual tax equal to the minimum franchise tax on each form of pass-through entity that affords limited liability;
- Revamping the limited liability company fee and making it more predictable and consistent as the minimum goal; and
- Coordinating the filing requirements for pass-through business entities and, if possible, creating a single form that could serve every entity.

Fairness. Burden necessarily becomes part of any discussion of taxes. The Task Force focused on elements it perceived as fundamentally unfair. The Task Force therefore recommends:

- Removing persons in the bottom 50% of adjusted gross incomes (excluding business income) from the tax rolls completely;
- Reducing the top personal income tax rate so that the people of California are not paying tax at a higher rate than corporations;
- Increasing, in addition or alternatively, the topside of each personal income tax bracket by 10% and then indexing tax brackets according to the provisions of current law;
- Allowing a \$250 tax credit to single filers with AGIs up to \$50,000 and a \$500 tax credit to joint filers with AGIs up to \$100,000; and
- Giving taxpayers credit for withholding or estimated tax payments before calculating the demand penalty.

Under the Task Force recommendations, none of the fifty percent of Californians whose adjusted gross incomes (excluding business income) are below approximately \$25,500 would pay income taxes. Californians with adjusted gross income from the current median up to \$50,000, if single, and \$100,000, if joint, would enjoy a tax

reduction as a result of reducing the top marginal tax rate, increasing the threshold for each higher marginal tax rate, and allowing the targeted tax credit. All other Californians would receive a tax reduction as a result of reducing the top marginal tax rate and increasing the threshold for each higher marginal tax rate.

Investment. The Task Force resolved to urge creation of a tax environment making California competitive with other states for both individuals and businesses. Specifically, the Task Force members believe that California should use the power of its tax law to encourage relocation and expansion in the state and discourage the flight of talent and capital. Thus, the Task Force recommends:

- Excluding 50% of certain capital gains from income in order to approximate the federal rate differential for capital gains;
- Ensuring business income treatment for investment income that the business people consider part of the corporation's overall business operations;
- Allowing individual taxpayers a lifetime exclusion of \$50,000 on realization of income from stock options; and
- Replacing the current apportionment formula with a single factor "sales" formula.

California Tax Today: An Overview

In the 1999 calendar year, California collected \$33 billion in personal income tax and \$5.75 billion in bank and corporation tax. Sales and use taxes provided \$17.5 billion and other miscellaneous sources contributed the remaining \$5.7 billion of general fund revenues in 1999. A review of the revenue trends of the last twenty years reveals significant increases in general fund revenues from the personal income tax in both real dollar terms and as a percentage of total revenues. For the 1999 calendar year, personal income tax revenues soared nearly five-fold from what they were in 1980, while total general fund revenues only tripled over the same period. In 1999, personal income taxes contributed nearly 55% of general fund revenues, up from about 37% twenty years earlier. Bank and corporation tax revenues approximately doubled in real dollar terms over that same period but the contribution of those taxes to general fund revenues fell from 13.9% to just 9.6%.

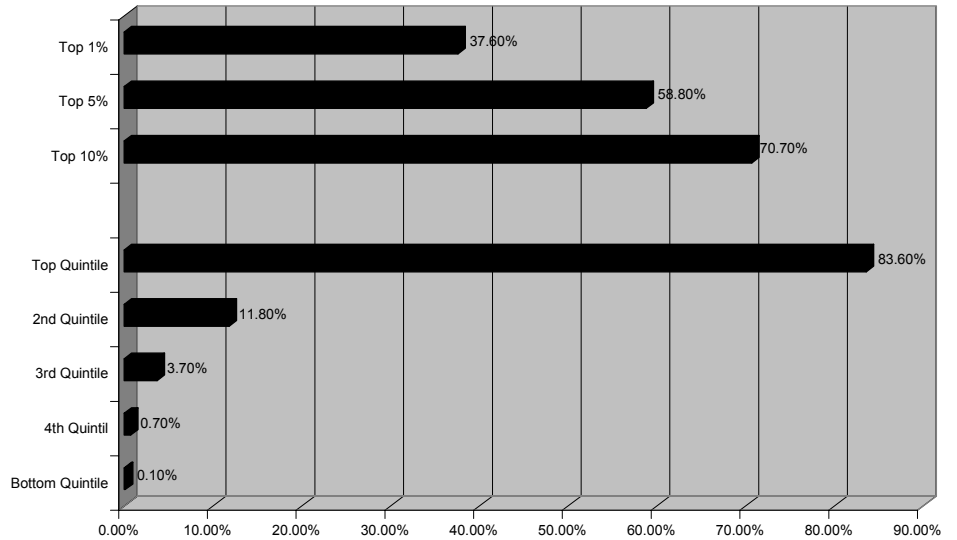
Revenue Trend Data
As a percentage of the General Fund

	1980	1990	1995	1999
Personal	37%	44%	45%	55%
Bank and Corporation	14%	12%	12%	10%
Sales and Use Tax	36%	35%	35%	29%
Other	13%	9%	8%	6%

Source: Franchise Tax Board

The majority of the personal income tax burden is borne predominantly by those at the very top end of the income spectrum. Thus, for 1997, only 1% of the personal income tax burden was carried by the population comprising the bottom 50% of all adjusted gross incomes (AGIs), while the population comprising the top 20% of AGIs was responsible for 83.6% of the tax burden. At the very top of the range, the top 10% paid fully 70.7% of the taxes; the top 5%, 58.8%; and the top 1%, 37.8%.

Distribution of Tax Burden by AGI Quintile and the Top 10, 5 and 1 Percent for 1997



Source: Franchise Tax Board

One other interesting figure regarding the personal income tax burden in California is that the amount of net capital gains reported by residents has grown rapidly in recent years. This growth from in the high teens to the low twenty billion dollars throughout the late 1980's and early to mid-1990's reached \$33 billion in 1996, \$47 billion in 1997, and \$61 billion in 1998. Common knowledge places that number on a continuing upward trend.

Conformity

Income tax simplification for Californians means, first and foremost, conformity to federal income tax law. Conformity promotes compliance and understanding on the part of taxpayers and eases administration on the part of both taxpayers and the Franchise Tax Board. Thus, the Task Force placed the primary goal for California's income and franchise tax laws squarely on conformity.

Problem

The goal of conformity has long been shared by the Legislature, where the pursuit of conformity is complicated by constitutional constraints and financial concerns. In addition, the federal legislative calendar is not parallel with California's and federal legislative proposals often change during the course of the session. It can thus be difficult for the Legislature to stay abreast of changes in the federal law. There have been times when California has trailed badly behind changes in federal law. This was especially true during the last decade when, despite several new federal tax laws, California let its conformity reference remain at January 1, 1993 for several years. Today, that reference is stuck at January 1, 1998, and while some changes made by the IRS Restructuring and Reform Act of 1998 have been adopted, others have remained stalled in committee.

Even when California conforms with federal law generally, non-conformity items always remain. Some differences are legally mandated and absolute, such as California's inability to tax interest on federal bonds or winnings received from the California State Lottery. Others, such as California's refusal to tax Social Security benefits, reflect the political landscape. Still, some aspects of federal law that have not found their way into California law have mainly been the result of the budgetary process.

Each federal law change being considered for a conforming inclusion in California's tax law is scored and assigned a revenue impact. If the revenue number assigned is perceived to be too large a revenue loss, that provision will quickly be doomed unless there is another provision that can "pay" for it. This is true even in the absence, leaving aside revenues, of an articulated policy reason for California not to conform to federal law. Importantly, the revenue impacts used to justify not making conformity changes are often based on static analyses that fail to account for a proposed provision's positive impact on the economy and future tax revenues. Also, narrowly focusing on that assigned revenue impact fails to acknowledge the negative impacts non-conformity generates in the community.

Recommendations

The Task Force recommends that the Legislature resolve to make conformity the central tax policy goal and that the Legislature articulate a non-revenue reason why California's tax policy should differ when it chooses not to conform to a particular federal tax law change. The Task Force recommends that the Legislature handle federal law changes on a timely basis.

Thus, the Task Force recommends the Legislature enact a statute providing that, beginning with federal tax law changes made on and after January 1, 2000, the Legislature will, within one year, incorporate or exclude those changes, and that any recent federal law changes not yet specifically incorporated or rejected will be considered without further delay. That statute should also provide that, for any federal tax law change it does not adopt, the Legislature articulate policy reasons — excluding solely revenue impact — for overriding the threshold principle of conformity.

Specific Conformity Items

During their discussions, Task Force members readily identified specific non-conformity items that they found especially glaring. The Task Force recommends that conformity be achieved with respect to each of those items without further delay.

Phase-out for Itemized Deductions

Problem

Both California and federal law provide taxpayers with exclusions, exemptions, deductions and credits, of which many are complex. When Congress (and the Legislature) seek to target these tax benefits at lower and middle-income taxpayers, further complications are introduced in the form of phase-outs. Phase-outs add significantly to tax return preparation time and tax return length, and potentially increase reporting errors. Some tax professionals consider phase-outs a hidden tax increase that creates irrational marginal income tax rates for affected taxpayers.

There is neither consistency of method among the items being phased-out nor, necessarily, conformity between the federal and California methods for the same item. For example, for certain taxpayers, both federal and California law restricts the amount of allowable itemized deductions but the phase-out methods differ, with California's being the more restrictive. For federal tax purposes, a

taxpayer whose itemized deductions are limited can lose deductions equal to 3% of adjusted gross income (AGI). For California tax purposes, assuming the AGI limitation on itemized deductions applies, the loss to taxpayers is greater not only because the limitations begin at a lower AGI, but also because the allowable deduction can be reduced by a hefty 6% of AGI. This double trouble is illustrative of the complexities California taxpayers face in understanding and figuring their tax liability each time the Legislature adopts a phase-out scheme that diverges from federal tax law.

Recommendation

The Task Force recommends eliminating the problematic lack of conformity in the phase-out itemized deductions. The Task Force specifically recommends that California lower the AGI reduction amount to 3%. The Task Force generally believes that phase-outs should not be a subject of fed-state differences. However, in this instance, the Task Force recommends not adopting the federal thresholds as doing so would import the federal marriage penalty into California law. If itemized deductions must be limited by phase-outs, the Task Force believes there is no reason why California should treat its taxpayers more harshly.

Impact

The Franchise Tax Board estimates \$161 million in direct savings to taxpayers from conforming to the federal government on the phase-out for itemized deductions.

Depreciation

Problem

On the personal income tax side, California has conformed to the federal depreciation provisions (the modified accelerated cost recovery system, or MACRS). On the corporate side, however, neither the MACRS, nor the federal accelerated cost recovery system (ACRS) depreciation methods for assets placed in service after 1986 have been adopted. This lack of conformity forces corporate taxpayers to calculate depreciation once for their federal return and then again, using a different method, for their California return. They must keep two sets of tax books to keep track of the same assets.

Recommendation

The Task Force recommends California correct this disparity and fully conform to federal depreciation rules for investment on or after January 1, 2000. The federal system is a deferred tax paying system. After the first 5 to 7 years of conformity, the transition to the

federal method will be complete and revenue neutral. The Task Force believes any temporary transition costs will be outweighed by the ultimate benefits of conformity and increased taxpayer compliance.

Impact

The Franchise Tax Board estimates an \$89 million deferral of tax cost in the first year for approximately 90,000 taxpayers from conforming to the federal government on depreciation.

Net Operating Losses

Problem

California allows only 50% of net operating losses (NOLs) to offset income in the following 5 years. This year, there is a proposal to increase the carryforward amount to 55%, with an eventual increase to 60%. Even this limited NOL reform differs significantly from federal law, which allows a 100% carryforward for 20 years and a 2 year carryback. Conformity on NOLs has long been sought, but to date the Legislature has found the impact too costly.

Recommendation

The Task Force recommends full conformity on NOL carryforward. Conformity to federal law on NOLs will lead to increased understanding and compliance on the part of taxpayers, resulting in more accurate returns. The Task Force recommends a 100% NOL carryforward for, at a minimum, a five-year period which conveys a sense of fairness. Taxable income is an annual concept, but corporate income from business operations is not so confined. These taxpayers have experienced real economic losses. They should be allowed to recognize those losses on their California returns to the extent they may have successes and income in subsequent years. While not yet achieving complete conformity on NOLs, this alternative proposal would better fall within the spirit of the federal provisions.

Impact

The Franchise Tax Board estimates \$33 million in direct savings to taxpayers from NOL carryforward conformity in its first benefit year. Limiting the NOL carryforward to a five-year period would lessen total tax savings in future years.

Charitable Contributions

Problem

California treats the contribution of appreciated property for charitable purposes less favorably than the federal law. Taxpayers who donate appreciated property are entitled to deduct the full value for federal purposes. Yet, California reduces the contribution by the amount of untaxed gain at the time of contribution on stock donated to private foundations and, for alternative minimum tax purposes, on all other property as well. This departure from the federal system adds complexity.

Recommendation

The Task Force recommends that California conform to federal law on this issue for the sake of clarity and consistency. A contribution of property is a surrender of its fair market value and the donor should be given full credit for that contribution. California should encourage this type of charitable activity rather than penalize it.

Impact

The Franchise Tax Board estimates \$10 million in direct savings to taxpayers from conforming to the federal law with respect to charitable contributions of appreciated property.

Simplicity

Simplicity and conformity are related. If one wants simplicity in state tax, conformity with federal law is a key to success. If one successfully advocates conformity, simplicity will result. Yet conformity is only a piece of the simplification puzzle. The Task Force recognized that other changes could be made that would simplify taxes in California and have no impact on conformity.

Alternative Minimum Tax

Problem

Congress originally designed the alternative minimum tax (AMT) to adversely impact taxpayers who invested in tax shelters. Congress believed that taxpayers who had a significant economic income, but an insignificant tax liability, were not paying their fair share. The AMT was intended to make certain that those taxpayers paid their full and fair share by adding back items of preference to recapture the tax they would have otherwise owed. With the demise of tax shelters, the AMT appears to have outlived its purpose. Indeed, with its complexity and compliance burden, AMT may well be the number one complaint about the tax system heard from tax professionals today.

Recommendation

The Task Force recommends repealing the AMT. The AMT presents California with an easy opportunity to lead rather than follow the federal law. It is one area where, despite urging conformity as the central theme, the Task Force saw conformity as wrong-headed. For both California and federal purposes, the AMT is an add-on tax separate from the regular tax. Conformity exists only in the sense that there is an AMT in both systems. California's AMT calculation is not the same as the federal calculation and both are complex. The Task Force believes that repealing the AMT would provide welcome tax simplification to California taxpayers.

Impact

The Franchise Tax Board estimates first year direct savings of \$120 million to individual taxpayers and \$130 million to corporate taxpayers from repealing AMT.

Pass-Through Business Entities

Problem

California currently assesses a “cost of doing business in the state” for pass-through entities enjoying limited liability, such as Subchapter S corporations, limited partnerships, limited liability partnerships, and

limited liability companies (LLCs). However, the type and amount of this toll charge varies. Toll charges for subchapter S corporations and LLCs remain awkward artifacts of the negotiations to allow Californians the flexibility of using these forms of doing business in the first place.

Limited partnerships and limited liability partnerships pay the minimum franchise tax. LLCs pay a flat fee, the amount determined by their gross receipts. The LLC fee can change from year to year depending on the outcome of the Franchise Tax Board's annual review pursuant to a complicated statutory formula. In the first year in which the statute required re-establishment of the LLC fee, the fee increased by 75%. The second year, it increased by another 20%. The tax on Subchapter S corporations, subject to the minimum franchise tax, equals 1.5% of net income (3.5%, if they are also financial corporations).

Recommendation

The Task Force recommends adopting a uniform toll charge for pass-through business entities by requiring each to pay only an annual tax equal to the minimum franchise tax. The Task Force members questioned the wisdom of artificially discriminating among entities, each of whom provides the basic features of pass-through tax treatment and limited liability. They expressed the belief that the varying toll charges distort business-planning choices. The Task Force believes that enacting this recommendation will simplify the law, make it more equitable, and assist California in competing with other states in attracting and retaining business growth. The Task Force members agreed that some toll charge was appropriate since, like regular corporations, these entities enjoy limited liability. The Task Force recommendation to restrict the toll charge to an amount equal to the minimum franchise tax is grounded in recognition of the fact that, unlike regular corporations, these entities each provide the benefit of pass-through treatment. It is at the Subchapter S corporation shareholder, the limited partner, or the LLC member level that tax is collected on the income generated by the entity's business operations. The Task Force further recommends that the LLC fee procedures be revamped and made predictable and consistent as the minimum goal.

Finally, the Task Force recommends that the Franchise Tax Board work to streamline and coordinate the reporting requirements for pass-through business entities. In particular, the Task Force urges the Franchise Tax Board to devise a short, simple, form that all these entities could use to pay their taxes.

Impact

The Franchise Tax Board estimates \$320 million in direct savings to approximately 40,000 Subchapter S corporations and \$89 million to limited liability companies from eliminating taxes and fees (other than an amount equal to the minimum franchise tax).

Dividends Received Deductions

Problem

California substantially conforms to the federal dividends received deductions with one important exception. Both systems exclude from income, to a certain extent, dividends paid to a corporation by an affiliated corporation. The vital difference is that California requires that the dividends received must have been paid out of income that was subject to either California's franchise tax, alternative minimum tax, or corporate income tax. In order to determine this, complex calculations must be made every year apportioning the payor corporation's income within and without California.

California's treatment of dividends received is burdensome and uncertain. The payee corporation might exclude dividends, only to later receive a notice proposing an additional tax assessment as the payor corporation had some income that was not taxed by California. Further, the apportionment calculation is tenuous and complicated and the requirement currently under attack in the courts.

Recommendation

The Task Force recommends that California conform to federal law concerning dividends received. The Task Force members believe that the possibility of unanticipated deficiencies and the time wasted doing the calculation are a drag on our tax system and would be eliminated by following federal law. With the clarity inherent in the federal system, taxpayers should be able to accurately comply with the law and report or exclude proper amounts.

Impact

The Franchise Tax Board estimates \$60 million in annual direct savings to taxpayers.

Unitary Business Credits

Problem

California has adopted various tax credits to encourage certain business activities. However, those credits can be stranded and left unutilized when earned in the context of a unitary business, even

though there is a sufficient total tax liability against which the credits could apply. This occurs when a unitary business is operated through a group of affiliated corporations rather than through a single corporation with divisions or branches.

It is the Franchise Tax Board's position that credits can only be used on a unitary group basis if the Legislature expressly provided for such treatment as to a particular credit. Thus, while a unitary group is treated as a single business operation whose separate corporate lines are ignored for purposes of determining how much income is taxable in the state, the Franchise Tax Board requires tax credits generated by that unitary business operation to be applied only against the tax liability of the particular corporation that directly made the investment giving rise to the credit. Translated, if that corporation is unable to use the credits as it has little or no separate tax liability, the credits cannot apply to other members of the group and will go unused.

The Franchise Tax Board's position partly stems from what it sees as the fundamental difference between a California combined report and a federal consolidated return. Each unitary group member doing business in California is subject to the corporate franchise tax and must file a combined report showing the unitary business income apportioned to it. If there is more than one unitary group member doing business in California, each can file a separate combined report or they can file a single combined report designating one of them as the key corporation. In the latter instance, each still has its own tax liability. In a consolidated federal return, there is always only one return and only one tax liability for which the companies are jointly and severally liable.

Some taxpayers maintain that the Franchise Tax Board's refusal to apply credits on a unitary group basis fundamentally conflicts with the theory of a unitary business and the related statutes. The issue is currently pending in the Court of Appeal in a case brought by the Guy F. Atkinson Company of California concerning solar energy credits.

Recommendation

The Task Force recommends that the Legislature specifically provide that credits are to be used on a unitary group basis. Doing so meets the criteria by which the Task Force determined to judge proposals. The overriding goal of conformity is served as it brings the California combined report closer to the federal consolidated return. Simplicity is served as the calculation is not complicated. Compliance is better assured since using credits on a unitary group basis comports with

how businesses believe the system works now. Fairness is promoted as spreading credits across the unitary group ensures that a business obtains the intended benefit of existing credits, regardless of whether that business operates through a series of divisions or corporations. The Task Force believes California should not penalize businesses that are engaging, on a unitary basis, in the very activities the Legislature seeks to encourage through the tax credits it enacts.

Impact

The Franchise Tax Board estimates \$70 million in tax savings for about 2,200 businesses from this recommendation.

Fairness

The Task Force believes certain areas need adjustment as they are unfair and inequitable. Specifically, the Task Force thinks the following areas should be changed in order for California's income tax system to maintain its sense of justice and integrity.

Low Income Taxpayers

Problem

The population comprising the bottom 50% of AGIs in California for 1997 was responsible for only 1% of the personal income tax revenues for that year. While many people in the bottom 50% of AGIs already have no tax liability, some will file returns to recover taxes they paid unnecessarily. The 100% refunds arise either because they did not make a separate withholding election for California purposes and application of the federal withholding tables resulted in over-withholding for state purposes, or because their financial circumstances changed for the worse during the year.

Recommendation

The Task Force recommends that the population comprising the bottom 50% of AGIs (excluding business income) be removed from the tax rolls. The Task Force members thought it only fair that this poorest sector of California be exempted from the income tax. Moreover, the Task Force members speculated that these lowest income filers might pay someone to help them file their return, compounding the financial burden the tax system places on them.

The Task Force also suggests that the Franchise Tax Board continue its outreach and education efforts so that persons who should not have to file do not find themselves in a position where they must do so. The fewer returns filed by people below the filing threshold, the less time, effort, and money that will be expended by them, by the Franchise Tax Board, and by the State Controller in processing the returns and refunds.

Impact

Approximately 2 million filers with incomes of \$25,500 or below would receive tax savings. Their average benefit is over \$181. The Franchise Tax Board estimates \$368 million in direct savings to these taxpayers.

Removing 50% of AGI

2000 Tax Year		
Adjusted Gross Income Class	Number of Returns Thousands	Total Tax Reduction (\$ Millions)
Less than \$ 20,000	1,489	\$157
\$ 20,000 - \$ 30,000	541	\$211
\$ 30,000 - \$ 50,000	0	\$0
\$ 50,000 - \$100,000	0	\$0
\$100,000 - over	0	\$0
Totals	2,030	\$368

Source: Franchise Tax Board

Example

Dick and Jane have no dependents and file a joint return. Their AGI is \$25,500 and their tax bill is \$138. Under this proposal, their taxes would decrease 100% and they would have a zero tax liability.

Tax Rates

Problem

California has the reputation of being a high tax state and with good reason. Individuals thinking of moving here must think twice, since California takes such a large bite of every dollar of income. California residents may consider leaving the state if they have the resources to do so. A quick review of comparable states reveals the fundamental deficiency with California’s personal income tax – its high tax rate. California’s top income tax rate is 9.3%, while other states have considerably lower top rates. Connecticut is at 4.5%; Illinois, 3%; New Jersey, 6.37%; New York, 6.85%; and Massachusetts, 5.95%. Furthermore, California’s top personal income tax rate is also higher than its corporate rate of 8.84%.

Recommendation

The Task Force recommends that the top personal income tax rate be reduced from 9.3% to, at a minimum, 8.84%. While corporations are vital to the California economy, there is an inherent inequity when

a business entity pays taxes at a lower rate than a real person. Personal income feeds, clothes, and houses families. The Task Force believes it appropriate that the personal income tax rate be put on par with, if not lower than, the corporate tax rate.

Impact

The Franchise Tax Board estimates \$1.15 billion in direct savings to 2.8 million filers for tax year 2000, for an average tax savings of over \$400.

Reducing Top Tax Rate of 9.3% to 8.84%

2000 Tax Year Adjusted Gross Income Class	Number of Returns Thousands	Total Tax Reduction (\$ Millions)
Less than \$ 20,000	0	\$0
\$ 20,000 - \$ 30,000	0	\$0
\$ 30,000 - \$ 50,000	340	\$7
\$ 50,000 - \$100,000	1,003	\$73
\$100,000 - over	1,469	\$1,068
Totals	2,812	\$1,148

Source: Franchise Tax Board

Example

Jose and Maria have one child and file a joint return. Their AGI is \$100,000. They claim a standard deduction of \$5,636 and one dependent. Jose and Maria have a \$5,259 tax bill. Under this proposal, they would save \$104 or 2% for a reduced tax bill of \$5,155.

Tax Brackets

Problem

California’s personal income tax is generally more progressive than the federal system, in part because of exemption credits and other items. In contrast to the federal system, however, each of California’s tax brackets has a low threshold. For 1999, the 9.3% rate begins on taxable income of \$34,548 for single filers and on taxable income of \$69,096 for joint returns. Those thresholds are within the middle range of the five federal tax brackets.

Recommendation

The Task Force recommends increasing the threshold for each personal income tax bracket by 10% and indexing them according to the provisions of current law. The Task Force members generally believe that California’s tax rates begin too low. For purposes of

indexing to tax rates for the 2000 year, this proposal would change the 1999 tax rate schedules for single filers and joint returns as shown below.

Single Filers			
1999 Tax Rate Schedule		Proposed 1999 Base Schedule	
On Taxable Income Over	Tax Rate	On Taxable Income Over	Tax Rate
\$0	1%	\$0	1%
\$5,264	2%	\$5,790	2%
\$12,477	4%	\$13,725	4%
\$19,692	6%	\$21,661	6%
\$27,337	8%	\$30,071	8%
\$34,548	9.3%	Above \$37, 904	9.3%

Joint Filers			
1999 Tax Rate Schedule		Proposed 1999 Base Schedule	
On Taxable Income Over	Tax Rate	On Taxable Income Over	Tax Rate
\$0	1%	\$0	1%
\$10,531	2%	\$11,584	2%
\$24,955	4%	\$27,450	4%
\$32,168	6%	\$35,385	6%
\$39,812	8%	\$43,793	8%
Above \$47,025	9.3%	Above \$51,727	9.3%

Impact

The Franchise Tax Board estimates \$1.2 billion in tax savings for about 8.7 million taxpayers from broadening the brackets in this fashion.

10% Tax Bracket Expansion

2000 Tax Year Adjusted Gross Income Class	Number of Returns Thousands	Total Tax Reduction (\$ Millions)
Less than \$ 20,000	1,215	\$15
\$ 20,000 - \$ 30,000	1,121	\$45
\$ 30,000 - \$ 50,000	2,152	\$192
\$ 50,000 - \$100,000	2,680	\$503
\$100,000 - over	1,486	\$460
Totals	8,654	\$1,215

Source: Franchise Tax Board

Example

Jordan, a single man with an AGI of \$35,000 who takes the standard deduction, currently would pay \$1,284 in personal income tax. Under this recommendation, Jordan would pay only \$1,154. He would save \$129 in taxes or 10% of his current tax bill.

Personal AGI Tax Credit

Problem

The income tax burden on middle-class Californians needs to be lessened. California has a progressive tax rate structure. This means that broadening tax brackets would reduce the burden on taxpayers subject to any marginal tax rate above the lowest rate. Other mechanisms exist to address issues relating to specific segments of the population. Tax credits, for example, can be targeted to the population sought to be impacted while not adversely affecting conformity in the determination of taxable income.

Recommendation

The Task Force recommends a \$250 tax credit for single filers with AGIs up to \$50,000 and a \$500 tax credit for joint filers with AGIs up to \$100,000.

Impact

The Franchise Tax Board estimates \$2 billion in direct savings to over 7.1 million taxpayers from this proposal.

Personal AGI Tax Credit

2000 Tax Year Adjusted Gross Income Class	Number of Returns Thousands	Total Tax Reduction (\$ Millions)
Less than \$ 20,000	1,694	\$159
\$ 20,000 - \$ 30,000	1,188	\$244
\$ 30,000 - \$ 50,000	2,162	\$622
\$ 50,000 - \$100,000	2,126	\$989
\$100,000 - over	0	\$0
Totals	7,170	\$2,014

Source: Franchise Tax Board

Demand Penalty

Problem

The demand penalty, like other penalties, is set at a percentage of the taxes owed, but California specifically refuses to recognize credits against the tax liability that exists on a taxpayer's account by virtue of withholding or estimated tax payments. In contrast to federal law, California blindly calculates the penalty amount without regard to such credits. For taxpayers in a refund position, California's penalty structure is a trap for the unwary. Indeed, during the recent filing season, at least one major electronic tax preparer advised that a return did not need to be filed by the due

date, if the taxpayer was owed a refund. While that practical advice was soundly based in federal law, it could prove dangerous for a taxpayer who read it to apply equally under California law.

The demand penalty, for which the Franchise Tax Board has been particularly criticized, has no federal counterpart. The Franchise Tax Board may impose a 25% penalty if a return is not filed after notice and demand. That means, for example, that a taxpayer with a \$1,000 tax liability and a \$400 refund is subject to a \$250 penalty. The Franchise Tax Board sponsored a bill this session (AB 296, Strickland/Kaloojian) to reform the unfair computation of the demand penalty. Criticism concerning the demand penalty has arisen in part because the penalty has been imposed automatically when the taxpayer has not timely responded to the demand, although the statute does not mandate imposition.

Recommendation

The Task Force joins the Franchise Tax Board in urging the Legislature to change the law so taxpayers are not unfairly penalized. The Task Force members believe that California's method of computing the demand penalty confuses and aggravates taxpayers, especially taxpayers whose return would have shown a refund. The Task Force members believe that it's only fair that taxpayers be credited with taxes paid on account, as they would be for federal purposes.

The Task Force further suggests that the Franchise Tax Board review its programs relating to the demand penalty and consider whether the statute requires imposing the penalty against taxpayers in a refund position or against first time offenders who, albeit belatedly, file a return in response to the demand notice. For those taxpayers, the Task Force members thought it a bit harsh to impose a discretionary penalty and insist it can only be removed if the taxpayer shows there was reasonable cause, generally something outside the taxpayer's control, for not responding in a timely manner.

Impact

The Franchise Tax Board estimates \$1 million in tax savings for approximately 90,000 taxpayers from this proposal.

Investment

The Task Force resolved to urge creation of a tax environment making California competitive with other states for both individuals and businesses. Specifically, the Task Force members believe that California should use the power of its tax law to encourage relocation and expansion in the state and discourage the flight of talent and capital.

Credit Incentives

Problem

Tax incentives are a valuable and acknowledged method of encouraging growth in desired industries and areas. Having incentives that are different from the federal system creates tension with the goals of conformity and simplicity.

Recommendation

The Task Force recommends that the Legislature undertake a comprehensive review of existing credits, extending those that have proved useful and repealing those whose utility has waned, and examine credits offered or proposed elsewhere to ensure that California business stays in California and remains competitive. The Task Force believes that the overall benefits that will inure to California generally from such incentives would outweigh any cost of nonconformity and added complexity. Also, to the extent the Legislature fashions tax incentives as credits while maintaining conformity in the tax base, non-conformity in tax incentive programs loses relevance as an issue.

Impact

There is no impact.

Capital Gains

Problem

Although California treats certain assets as “capital” in nature, this distinction does not matter because any gain from capital assets is taxed at the ordinary income rate. This differs significantly from the federal system, which awards a preferential tax rate on capital assets held for the appropriate period.

Before 1987, California excluded a certain percentage of gain on a capital asset, depending on the holding period, which resulted in an effective preferential tax rate on capital gains. This changed when

California conformed to then-current changes in the federal law, and ever since California has taxed capital gain at ordinary income rates.

Recommendation

The Task Force recommends that California stop treating capital gains generally as ordinary income and approximate the differential federal tax rate on capital gains by excluding from income 50% of capital gains on assets held over one year. This exclusion effectively cuts the tax on long-term investments in half, thus encouraging investment activities. Additionally, this change will also help retain businesses, talent, and capital, because California will be on par with other states that reward investment, such as Massachusetts, and the incentive to move out-of-state before recognizing gains will be reduced.

Impact

The Franchise Tax Board estimates \$3 billion in direct savings to taxpayers from the proposed 50% capital gains exclusion.

Stock Options

Problem

California businesses have expressed concerns about their continued ability to attract educated and talented individuals. Favorable tax policies can assist in the area of personnel recruitment and retention.

Recommendation

The Task Force recommends that California allow a lifetime exclusion from income of \$50,000 of gain arising from the exercise of stock options. Adoption of this proposal will serve two purposes. First, it will help businesses attract talented employees to our state and keep them here. Second, as this will attract a skilled workforce, it will also influence businesses to locate here. Thus, both employers and talented employees will have an incentive to locate in California. This will boost our economy resulting in positive long-term effects.

Impact

The Franchise Tax Board estimates \$1.7 billion in direct savings to taxpayers.

Business “Investment” Income

Problem: California combined reports differ from federal consolidated returns as not all income of the corporations in the

combined report is taxable by California. Due to constitutional constraints, California can only tax California-source income. For a corporation with income from within and without the state, income must first be characterized as either business or non-business income, with the business income being apportioned to California and the non-business income being specifically allocated to the place where the income arose.

The business/non-business distinction is peculiar to the unitary method of taxation and has long been a matter of concern for companies and often the subject of dispute. If it is non-business income, income from intangibles is specifically allocated to the company's corporate domicile unless the intangible has acquired a business situs elsewhere. Some tax managers might say that the Franchise Tax Board will classify such income as business income if the company's corporate domicile is out-of-state and as non-business income if the corporate domicile is in California. Thus, a California headquartered company with income from its treasury operations risks having all this income allocated to California, rather than only a portion.

Non-business income is income that is neither transactionally nor functionally related to a corporation's regular course of business. Generally speaking, funds held as working capital are viewed as part of the unitary business assets while funds not necessarily for the short-term working capital needs of the business are viewed as generating non-business income. That characterization may have made sense in a traditional corporate world. Today other considerations may apply. Corporations are making "investments" which they clearly view as part of their business operations and in furtherance of their business goals. Yet a company's use of the term "investment" to describe its portfolio strategy in internal memoranda, press releases, and annual reports could backfire when the Franchise Tax Board comes to audit.

Companies already located in California would rather not separately incorporate their treasury operations and establish their corporate domicile out-of-state. Businesses are no longer in the traditional manufacturing and merchant mode. They see their charge as including furthering similar business development, and have deployed their available capital in other than traditional plant operations. As such, they expect the capital deployment to be considered part of the corporation's unitary business operations and the resulting income to be treated as business income subject to apportionment.

Recommendation

The Task Force recommends that companies be allowed to elect to treat their so-called investment portfolio income as business income. The election should not be changeable from year to year to avoid gamesmanship, but should be structured so that it will fairly reflect the operational sense of the corporate managers. An election would likely be the necessary mechanism in order to be certain of passing constitutional muster. California has suffered from the flight of corporate headquarters over recent years. Positive steps should be taken to protect against further possible erosion.

Impact

The Franchise Tax Board estimates \$18 million in direct savings for about 750 corporate taxpayers.

Apportionment Factor

Problem: The formula used to apportion business income to California consists of three factors — property, payroll, and sales — with the sales factor receiving double weight. By recently choosing to double weight the sales factor, California has moved away from the traditional three-factor formula of the Uniform Division of Income for Tax Purposes Act. Other states have similarly moved away from the traditional formula with more states seeking to emphasize the sales factor. The list of states using a single factor “sales” formula, or weighting the sales factor more than twice, includes Illinois, Iowa, Massachusetts, Minnesota, Nebraska, Ohio, Pennsylvania, and Texas.

California property values and personnel costs are high, perhaps disproportionately high, and some companies may feel that California dollars do not disproportionately give rise to their income as compared to the dollars spent on business property and personnel elsewhere in the world. Product prices may be more consistent, and those same companies may believe that sales are a better proxy for determining the amount of business operations in a state.

Recommendation

The Task Force recommends replacing the current apportionment formula with a single factor “sales”. Use of a single factor “sales” will avoid penalizing companies for owning property or employing people in California. Those are activities California should encourage, as they will further grow the economy. A revision of the apportionment

formula will result in a more competitive position and assist in attracting and retaining businesses.

Impact

The Franchise Tax Board estimates \$96 million in net direct savings. Approximately 5,800 California based corporations would receive \$548 million. Approximately 8,900 corporations based outside of California would pay additional taxes.

Appendix and Acknowledgments

State Controller Kathleen Connell wishes to extend her sincere appreciation to the individuals whose commitment and ideas are reflected in these recommendations:

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