Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Chan	Analyst:	Rachel Coco	Bill Number:	AB 1177
Related Bills:	See Legislative History	Telephone:	845-4328	Amended Date:	May 23, 2006
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT:	Tax Rates/Increase To 10% & 11%/Education Finance

SUMMARY

This bill would add two personal income tax (PIT) rates, 10% and 11%, and would make the alternative minimum tax (AMT) rate 8.5%. The additional revenue generated would be used to fund education.

SUMMARY OF AMENDMENTS

The May 23, 2006, amendments removed language relating to education and added language to increase the PIT and AMT rates.

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

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to protect education funding and vital health and safety services.

EFFECTIVE/OPERATIVE DATE

As an urgency measure, this bill would be effective immediately upon enactment and operative for taxable years beginning on or after January 1, 2006.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Federal law imposes five different income tax rates on individuals ranging from 10% to 35%. Existing state law imposes six different PIT rates ranging from 1% to 9.3%. Each tax rate applies to a different level of income known as a "tax bracket." Existing state law requires the Franchise Tax Board (FTB) to recalculate the tax brackets each year based on the change in the California Consumer Price Index.

Board Position:			Department Director	Date
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Federal law provides a personal income AMT rate of 26%. Existing state law provides a personal income AMT rate of 7%. A taxpayer with substantial income can use preferential tax benefits, such as exclusions, deductions, and credits, to reduce their income tax liability. AMT was established to ensure that a taxpayer who can use preferential tax benefits does not completely escape taxation.

Proposition 63 was approved by voters in the November 2004 General Election and provides a dedicated funding source for the expansion of mental health services (MHS) by imposing an additional 1% tax, not subject to reduction by credits, on the portion of a taxpayer's taxable income that exceeds $1 million.

THIS BILL

The current top PIT rate is 9.3%. For taxable years beginning on or after January 1, 2006, this bill would establish a PIT rate of 10% for:

- Single filers (including married filing separate) whose taxable income is over $149,739 and equal to or less than $299,477,
- Joint filers whose taxable income is over $299,478 and equal to or less than $598,954, and
- Head of household filers whose taxable income is over $203,817 and equal to or less than $407,634.

This bill would establish a PIT rate of 11% for:

- Single filers (including married filing separate) whose taxable income is over $299,477,
- Joint filers whose taxable income is over $598,954, and
- Head of household filers whose taxable income is over $407,634.

For example:

2005 Tax Brackets And Rates For Single Filers

$0	-	$6,319	1.0%
$6,320	-	$14,979	2.0%
$14,980	-	$23,641	4.0%
$23,642	-	$32,819	6.0%
$32,820	-	$41,476	8.0%
$41,477	-	$999,999	9.3%

Projected 2006 Tax Brackets And Rates For Single Filers As Proposed

$0	-	$6,578	1.0%
$6,579	-	$15,593	2.0%
$15,594	-	$24,610	4.0%
$24,611	-	$34,165	6.0%
$34,166	-	$43,177	8.0%
$43,178	-	$149,739	9.3%
$149,740	-	$299,477	10%
$286,844	-	And over	11%

Note: The 2006 tax bracket amounts identified above are only projections at this time due to the annual indexing adjustment, which is based on data that is unavailable at this time.

This bill provides that the 10% and 11% brackets would be adjusted annually for inflation.

This bill also would increase the AMT rate from 7% to 8.5% for taxable years beginning on and after January 1, 2006.

This bill specifies that the amount of tax imposed under the increased tax rates shall be reduced on a dollar-for-dollar basis by an amount equal to the tax imposed under Proposition 63. For example, a taxpayer whose taxable income is $1.5 million would be subject to a tax of $5,000 under Proposition 63, to be deposited into the MHS fund. Under this bill, the $5,000 of tax imposed under Proposition 63 would be subtracted from the amount of the taxpayer's total tax liability. Because the tax imposed under Proposition 63 is deposited into the MHS fund rather than the General Fund, the revenue increase from the 11% tax rate is less than if Proposition 63 had not been enacted.

This bill would also appropriate the revenue generated by the increased tax rates to fund education as follows:

- $1.157 billion to Section A of the State School Fund for allocation by the Superintendent of Public Instruction (SPI) during fiscal year 2006/07.
- $143 million to Section B of the State School Fund for allocation to community college districts by the Chancellor of the California Community Colleges (CCC) for fiscal year 2006/07.
- $801 million to the SPI to be allocated to school districts without regard to fiscal year for purposes of reimbursing school districts for state-mandated local costs.
- $99 million to the Chancellor of the CCC to reimburse community college districts for state-mandated local costs and other one-time purposes.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

LEGISLATIVE HISTORY

Proposition 82 would impose an additional 1.7% tax on the portion of a taxpayer's income that exceeds specified threshold amounts. The additional revenue would be used to provide funding for preschool programs. This initiative failed to pass during the June, 2006, Primary.

AB 6 (Chan, 2005), AB 4 (Chan, 2003), and SB 1255 (Burton, 2002) contained language similar to the language of this bill. All three bills failed to pass out of their house of origin by the constitutional deadline.

ACA 24 (Cohn, 2005) would impose an additional tax at the rate of 1/40th of one percent on the taxable income of a taxpayer that exceeds $1 million to fund domestic violence shelter services. This constitutional amendment failed to pass out of the house of origin by the constitutional deadline.

Proposition 63, enacted during the November 2, 2004, General Election, imposes an additional tax of 1% of the amount of a taxpayer's taxable income that is over $1 million and precludes any reduction in this tax by any otherwise allowable credits.

SB 169 (Alquist, Stats. 1991, Ch. 117) increased the tax rates on individuals for taxable years beginning on or after January 1, 1991, and before January 1, 1996, by adding 10% and 11% brackets and increasing the AMT rate from 7% to 8.5%.

PROGRAM BACKGROUND

In the early 1990s, California faced a severe recession, which resulted in significant shortfalls in the state budget. In response, the state acted to increase revenues and reduce expenditures. As one way of increasing revenues, the state imposed a temporary income tax rate increase in 1991, adding 10% and 11% rates for the highest income taxpayers. This temporary tax increase was in effect for four taxable years and sunset for taxable years beginning on or after January 1, 1996.

OTHER STATES' INFORMATION

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

Illinois, Massachusetts, and *Michigan* impose a flat tax of 3%, 5.3%, and 3.9%, respectively. *Minnesota* has a progressive rate with a maximum tax rate of 7.85%. These rates apply to the 2005 taxable year.

In 2004, *New Jersey* began imposing an additional tax of 2.6% on taxpayers earning more than $500,000. The additional tax increases the top tax rate from 6.37% to 8.97%. The revenue generated is to support property tax relief for the state's lower income taxpayers and senior citizens.

For taxable years 2003 through 2005, *New York* added two additional tax rates, which increased the maximum rate from 6.85% to 7.5% and 7.7%. For taxable years beginning after 2005, the rates revert back to a maximum of 6.85%.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue gains:

Estimated Revenue Impact of AB 1177 Taxable Years Beginning On Or After January 1, 2006 Assumed Enactment After June 30, 2006 ($ in Billions)			
Fiscal Year	2006-07	2007-08	2008-09
	+$3.3	+$2.5	+$2.7

This estimate does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

The above estimate was generated using the department's personal income tax model. The total revenue amount generated by the tax model was then reduced by the amount of tax imposed under Proposition 63 since the revenue generated from that tax is deposited into the MHS fund instead of the General Fund. This bill is estimated to impact approximately 460,000 taxpayers. The estimates should be considered preliminary because an updated personal income tax model will be available within a few months.

LEGISLATIVE STAFF CONTACT

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