Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Hollingsworth	Analyst:	Jahna Alvarado	Bill Number:	SB 13
Related Bills:	See Legislative History	Telephone:	845-5683	Introduced Date:	December 1, 2008
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: PIT Rates/Reduce Marginal Rates On Or After January 1, 2009, & Upon Voter Approval Eliminate Mental Health Services Surcharge Enacted By Proposition 63

SUMMARY

This bill would do the following:

- Reduce Personal Income Tax (PIT) rates over a five year period to zero,
- Repeal the alternative minimum tax (AMT) at the end of that five year period,
- Upon voter approval, repeal the 1% Mental Health Tax (MHT) imposed on taxpayers with taxable income in excess of $1 million dollars, and
- Change the method for taxing non-residents and part-year residents.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to eliminate the California PIT and alleviate the burden on individuals.

EFFECTIVE/OPERATIVE DATE

This bill, with the exception of the repeal of the 1% MHT, would be effective January 1, 2010, and would be specifically operative for taxable years beginning on or after January 1, 2009. The proposed repeal of the 1% MHT would be effective and operative upon voter approval.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Federal law imposes six 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 range of taxable 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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Taxpayers with preferential tax benefits, such as exclusions, deductions, and credits, use those benefits 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. Federal law generally provides personal income AMT rates of 26% and 28%. Existing state law provides a personal income AMT rate of 7%. The federal AMT lacks a provision for automatic adjustments based on inflation, which is resulting in application of AMT to more taxpayers and yearly adjustments by Congress to the application threshold. The California AMT has an automatic adjustment, which assures that the state AMT applies to upper income taxpayers only.

Starting with the 2005 taxable year, current state law imposes an additional 1% MHT, not subject to reduction by credits, on the portion of a taxpayer's taxable income that exceeds $1 million. The estimated revenue as defined, from the additional 1% MHT is deposited into the Mental Health Services Fund on a monthly basis, and is subject to an annual adjustment as determined by the Department of Finance.

For taxable years 2009 and 2010, the PIT rates will increase by 0.25%. If certain notification regarding funds related to the American Recovery and Reinvestment Act of 2009, (Public Law 111-5) is given by the Director of Finance on or before April 1, 2009, the rates will alternatively increase by 0.125%. The PIT rate increase may be extended if Proposition 1A is approved by the voters in the May 19, 2009, special election.

Non-residents are taxed on income sourced within California, while part-year residents are taxed on all income from all sources while a resident of California. Beginning with the 2002 taxable year, state law set rules for calculating loss carryovers, deferred deductions, and deferred income, and implemented a tax computation method to recognize those items. Tax is computed by multiplying the California taxable income by an effective tax rate.

<u>THIS BILL</u>

Beginning with taxable year 2009, this bill would incrementally reduce the existing PIT rates to zero by the year 2013.

The tax rates proposed by this bill are as follows:

<u>Proposed PIT Rates</u>

Current[1]	*2009*	*2010*	*2011*	*2012*	*2013*
1%	0.80%	0.60%	0.40%	0.20%	0%
2%	1.6%	1.2%	0.80%	0.40%	0%
4%	3.2%	2.4%	1.6%	0.80%	0%
6%	4.8%	3.6%	2.4%	1.2%	0%
8%	6.4%	4.8%	3.2%	1.6%	0%
9.3%	7.54%	5.58%	3.72%	1.86%	0%

[1] PIT rates in existence prior to the enactment of ABX3 3 (Evans, Stats. 2009, Ch. 18)

In addition, this bill would do the following:

- Provide contingent enactment language that would eliminate the 1% MHT, as well as the associated provisions specifying the allocation of the MHT funds, subject to a ballot initiative and voter approval,
- As of January 1, 2013, repeal the California AMT, and
- Change the method for taxing non-residents and part-year residents described below.

This bill would calculate the tax for non-residents and part-year residents on income with a source in California at the same tax rates that would apply to a resident of California. The tax would be computed upon total income as if that individual were a resident for the entire year, and would be prorated based upon the ratio of adjusted gross income (AGI) with a source in California over AGI from all sources.

IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author's office to resolve this concern and other concerns that may be identified.

TECHNICAL CONSIDERATIONS

This bill would eliminate the defined term "taxable income of a nonresident or part-year resident" but does not modify or otherwise alter other provisions of law related to source rules where this term is used. (Revenue and Taxation Code (R&TC) sections 17301, 17302, 17306, 17307, and 17062.) This could cause confusion and errors in computing tax and credits for nonresidents and part-year residents.

This bill was introduced prior to the enactment of ABX3 3 (Evans, Stats. 2009, Ch. 18) and does not address the changes made to R&TC section 17041 by ABX3 3. The author may wish to amend this bill to specifically address the temporary PIT rate increase created upon the enactment of ABX3 3.

LEGISLATIVE HISTORY

ABX3 3 (Evans, Stats. 2009, Ch.18), among other things, temporarily increases the PIT rates. This change is effective for taxable years 2009 and 2010. The temporary increase would be extended if ballot propositions are approved by the voters in the May 19, 2009, special election.

SB 57 (Hollingsworth, 2007), a similar bill, would have incrementally reduced the PIT rate to zero by 2011, would have eliminated the AMT as of January 1, 2011, and would have eliminated the MHT upon voter approval. This bill failed to pass out of the Senate Revenue & Taxation Committee by the constitutional deadline.

Proposition 63 (Steinberg), approved by voters in the November, 2004, General Election, imposes a 1% tax on taxable incomes in excess of $1 million to provide a dedicated funding source for the expansion of mental health treatment options for children, adults, and seniors.

AB 1740 (Assembly Revenue & Taxation Committee, Stats. 2004, Ch. 13), among other things, clarifies the method of calculating the taxable income of nonresidents and part-year residents to eliminate concerns that were identified during the implementation of AB 1115 (Stats. 2001, Ch. 920).

AB 1115 (Assembly Revenue & Taxation Committee, Stats. 2001, Ch. 920) made major changes to the manner that nonresidents and part-year residents compute their tax for taxable years beginning on or after January 1, 2002, to ensure that California does not tax nonresidents and part-year residents (for the period of nonresidency) on income from sources outside this state.

AB 17 (Hollingsworth, 2001), a similar bill, would have incrementally reduced the PIT rate to zero by 2005 and eliminated the AMT beginning in 2005. AB 17 failed passage in the Senate Revenue and Taxation Committee.

AB 643 (Baldwin, 1997) would have provided a 10% reduction in PIT rates phased in over two years; this bill remained in the Assembly Revenue and Taxation Committee.

SB 1326 (Alfred E. Alquist, Stats. 1982, Ch. 372) changed the method of taxation of nonresidents or part-year residents so that the tax upon income having a source in California would be taxed at the same tax rates that would apply to a resident with the same total income.

OTHER STATES' INFORMATION

The states surveyed include *Florida, 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. None of the states impose a tax that is similar to the additional 1% MHT.

Other State	**PIT Rate**	**AMT Rate**
Illinois	3% of net income (Flat tax)	None
Massachusetts	5.3% wages etc. 12% on capital gains (Flat tax)	None
Michigan	4.35% of taxable income	None
Minnesota	5.35 % to 7.85% of taxable income	6.4%
New York	4% to 6.85% of taxable income	Minimum Income Tax Rate 6% New York state residents; 2.85% New York city residents

Florida does not have a PIT.

Illinois allocates and apportions the income of nonresident individuals to determine the amount of income that is sourced to and, thus, is taxable by that state. Income of a part-year resident is sourced to Illinois for the part of the year that the individual was a resident, and apportioned inside and outside of the state for the part of the year the individual was a nonresident.

Under *Massachusetts* law, a nonresident is taxed only on income from sources within that state. Nonresidents are entitled to deductions only to the extent they relate to or are allowable against the income subject to tax in *Massachusetts*.

Michigan provides that nonresidents and part-year residents are taxed on all income earned in *Michigan*, or attributable to *Michigan*. Allocation and apportionment rules are provided for items such as business income, rents, royalties, interest, gains, and losses.

New York taxpayers are subject to tax on income received from *New York* sources while a nonresident and on all income received while a *New York* State resident. Tax is calculated on the federal AGI and includes all gains, losses and deductions, and is apportioned based on a percentage that represents *New York* source income.

FISCAL IMPACT

This bill would not significantly impact the department's costs. It would require changes to tax forms, publications, websites, and information systems, which could be accomplished during routine annual changes. A plan would need to be established to phase out PIT program areas throughout the department.

Any savings that might result from this proposal would be re-directed towards other revenue producing programs.

ECONOMIC IMPACT

Revenue Estimate

Based on data and assumptions discussed below, the revenue loss from this bill would be as follows:

Estimated Revenue Loss of SB 13 – Phase-out and Repeal PIT, MHT and AMT Effective For Tax Years On Or After January 1, 2009 Enactment Assumed After June 30, 2009 ($ in Billions)				
	2009-10	**2010-11**	**2011-12**	**2012-13**
Repeal PIT	-$22.7	-$21.8	-$24.2	-$39.5
Repeal Mental Health Fund	$ 0	-$ 1.5	-$ 1.1	-$ 1.2
Total Revenue Loss	-$22.7	-$23.3	-$25.3	-$40.7

While this bill would be effective for tax years beginning on or after January 1, 2009, repealing the MHT is subject to voter approval and is assumed to apply for taxable years beginning on or after January 1, 2010. Additional detail is provided in the "Revenue Discussion" section.

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 revenue impact of this bill would depend on the number of taxpayers, their income, and the voter approval of the MHT provision.

This personal income tax revenue estimate is based on the department's latest personal income tax model, including residents and part-year residents. The 2009-10 fiscal year is higher because it represents all of the 2009 calendar year, plus part of the 2010 calendar year. The jump in revenue loss in 2012-13 is the result of the repeal of the AMT as of January 1, 2013.

For purposes of this revenue estimate, it was assumed that voters approved a repeal of the 1% surtax for tax years beginning on or after January 1, 2010, but that taxpayers would not make changes to their estimated payments until September 2010 and January 2011. The Mental Health transfer projections from the Department of Finance are based on the most current available return processing information. Under current law, revenues from the 1% surtax would be transferred to the Mental Health Fund.

ARGUMENTS/POLICY CONCERNS

Because this bill would reduce regular PIT rates incrementally without making a corresponding reduction in the AMT rate, this bill could increase the number of taxpayers who would owe AMT between taxable years 2009 and 2013.

The income tax paid by businesses operating as sole proprietorships would be reduced and eventually eliminated by this bill. Businesses organized as a C or S corporation also pay a tax measured by income and would continue to pay this tax under existing Corporation Tax Law, thus creating different treatment for businesses based on entity type.

LEGISLATIVE STAFF CONTACT

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