Overview of the California Tax and Revenue System

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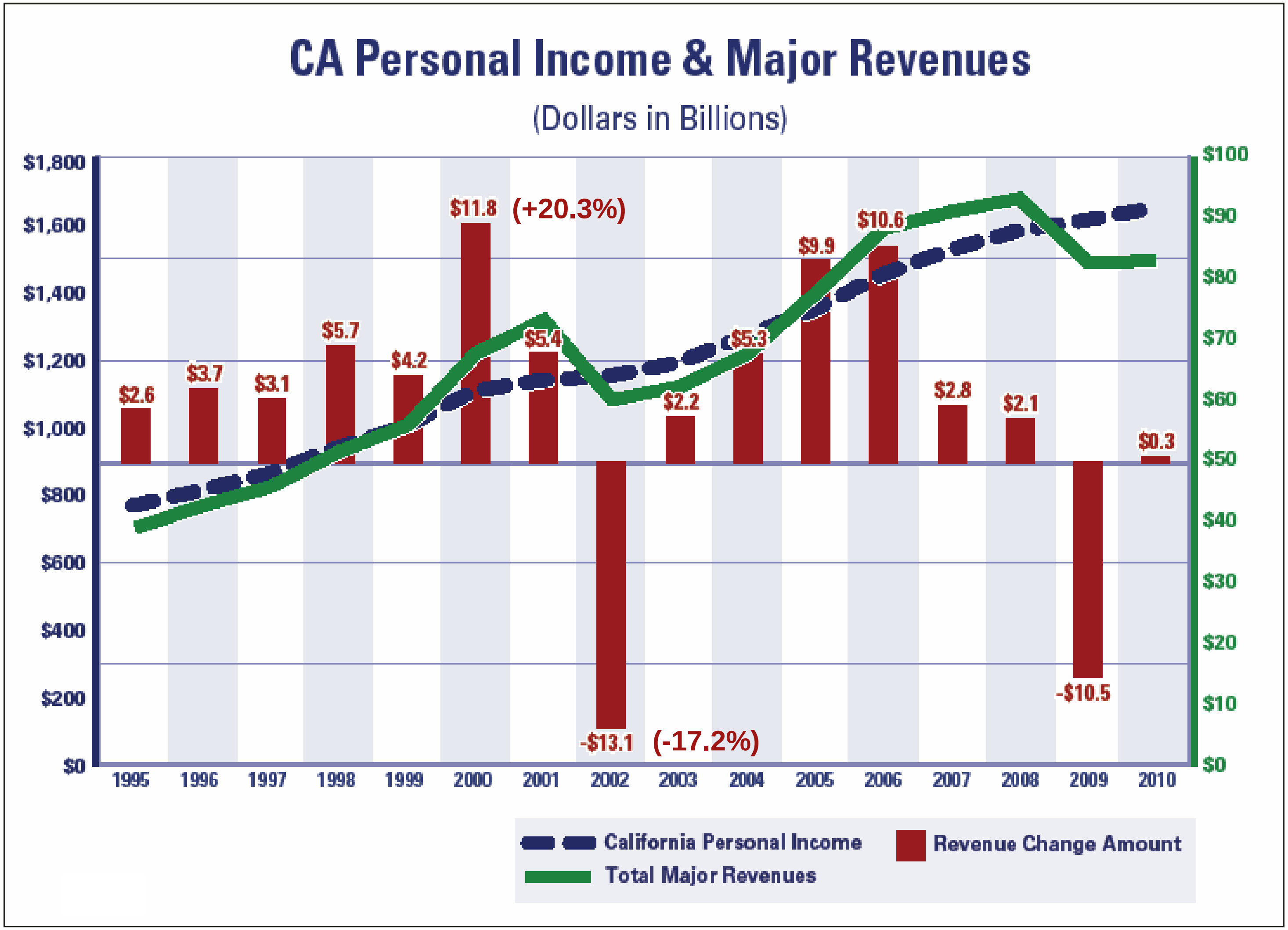
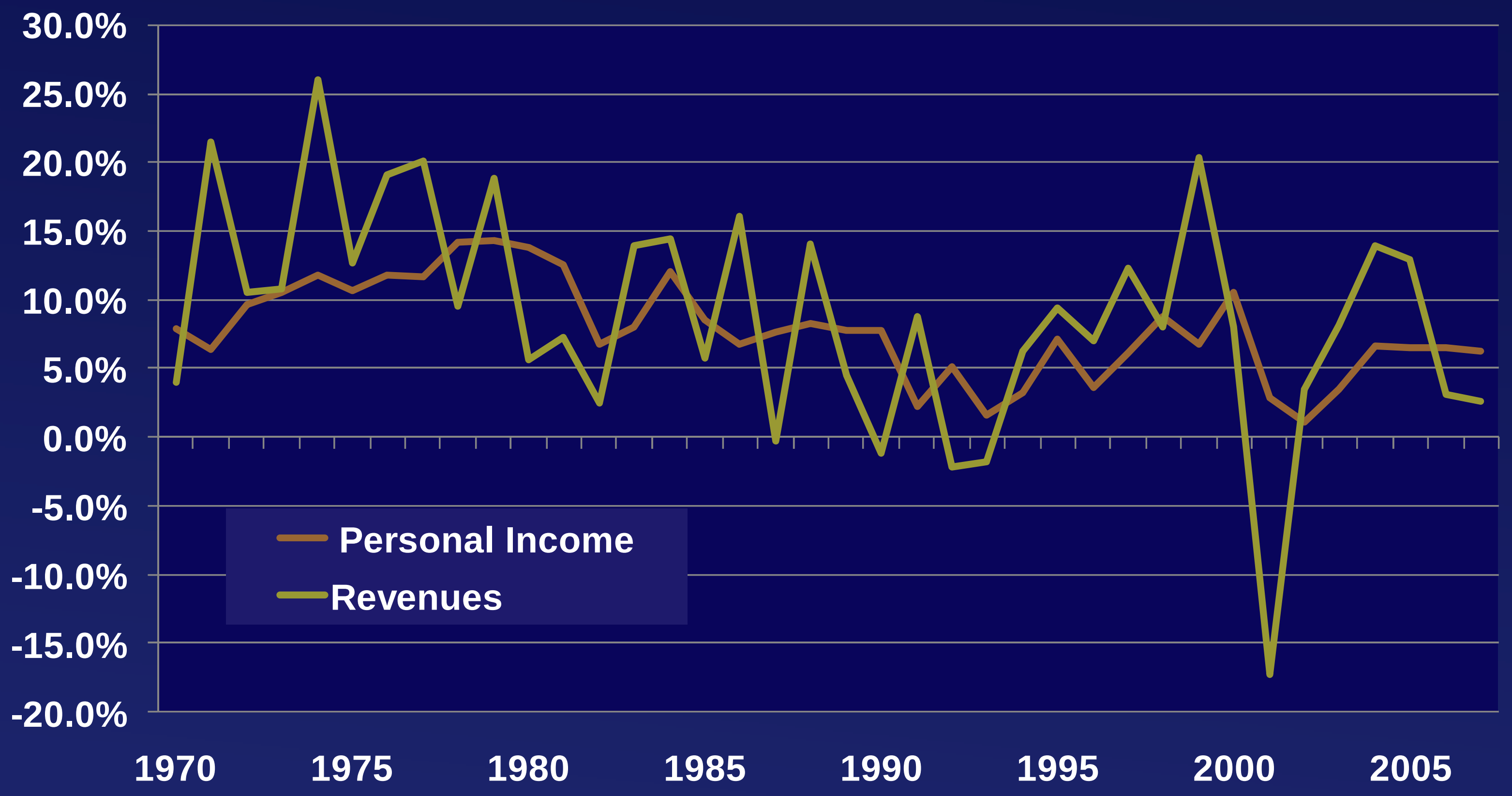

CA Personal Income & Major Revenues
(Dollars in Billions)
$1,800
$1,600
$1,400
$1,200
$1,000
$800
$600
$400
$200
$0
$100
$90
$80
$70
$60
$50
$40
$30
$20
$10
$0
$2.6
$3.7
$3.1
$5.7
$4.2
$11.8 (+20.3%)
$5.4
-$13.1 (-17.2%)
$2.2
$5.3
$9.9
$10.6
$2.8
$2.1
-$10.5
$0.3
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
California Personal Income
Revenue Change Amount
Total Major Revenues

Revenues are More Volatile Than the Economy



General Fund Variability

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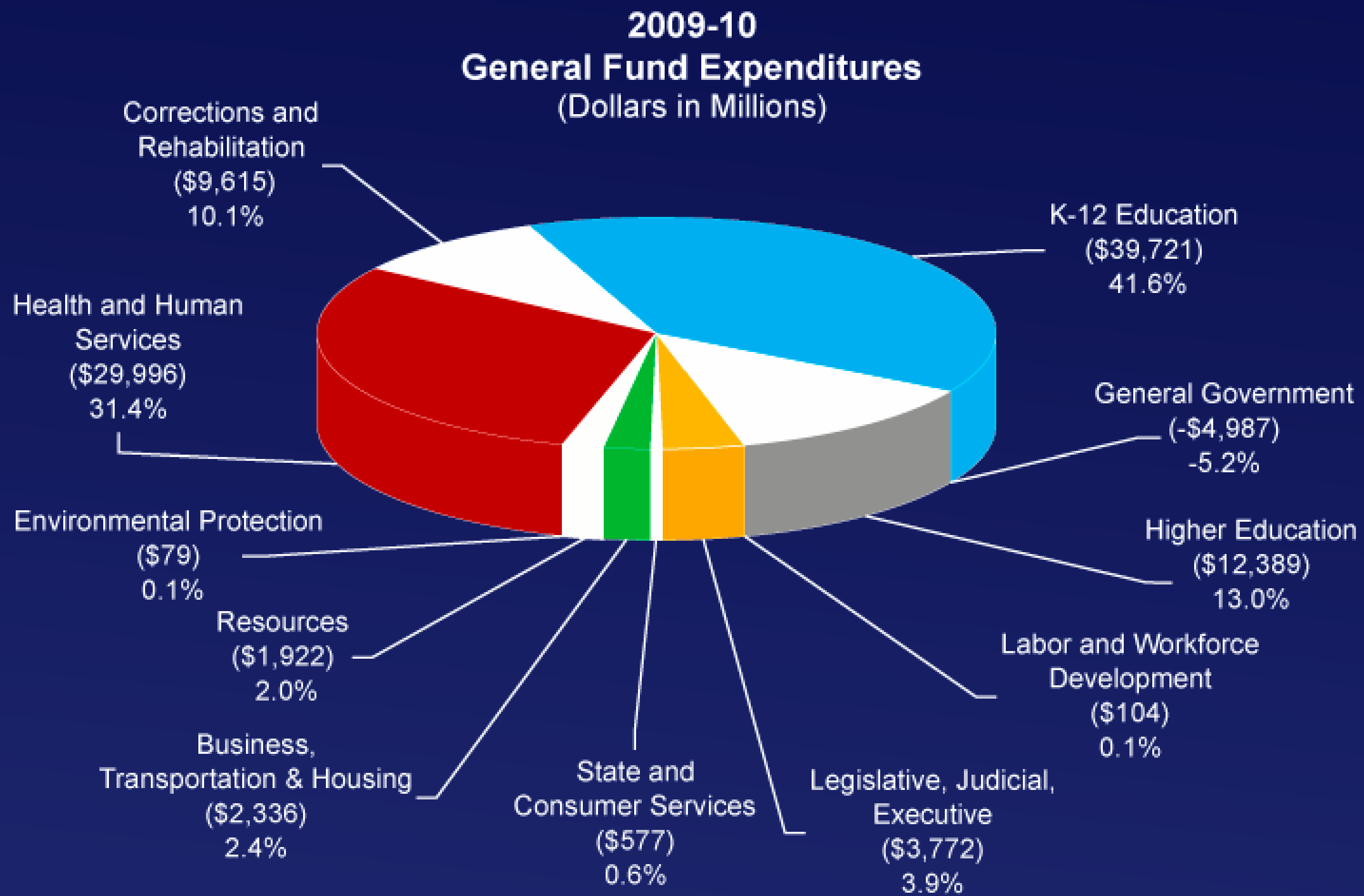
2009-10 Governor's Budget
Baseline Workload Budget

(Dollars in billions)

2009-10 General Fund Expenditures

(Dollars in Millions)



Remedies for Mismatch of Revenues and Expenditure

- Reduce revenue volatility
- Establish sufficiently large cushion (reserve) to offset revenue reductions during downturns

Principles for a Good Tax System

- Establish 21st century tax structure that fits with state's 21st century economy;
- Stabilize state revenues and reduce volatility;
- Promote the long-term economic prosperity of the state and its citizens;
- Improve California's ability to successfully compete with other states and nations for jobs and investments;
- Reflect principles of sound tax policy including simplicity, competitiveness, efficiency, predictability, stability and ease of compliance and administration;
- Ensure that tax structure is fair and equitable.

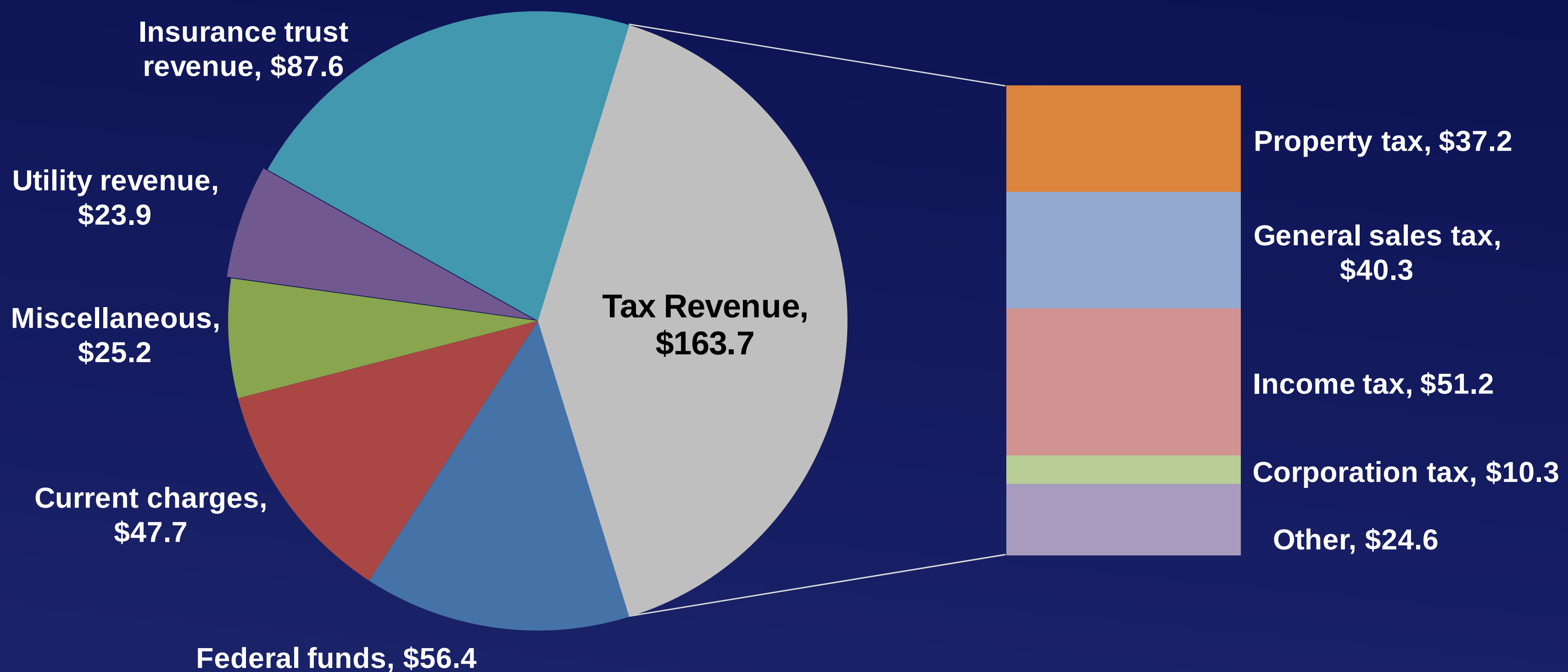
Where Do We Rank?

	2006			
	Own Source Revenue		Tax Collections	
	% Personal Income	Rank	% Personal Income	Rank
Louisiana	21.0%	3	14.0%	6
New York	21.0%	4	15.7%	2
New Mexico	20.9%	5	12.9%	9
Indiana	19.8%	6	11.9%	17
Utah	18.9%	12	11.8%	19
South Carolina	18.3%	14	10.3%	44
Oregon	17.6%	17	10.8%	40
California	**17.6%**	**18**	**12.1%**	**14**
Ohio	17.2%	22	11.8%	18
Minnesota	16.9%	26	11.8%	20
Washington	16.6%	27	11.2%	29
Michigan	16.4%	33	10.9%	38
New Jersey	16.3%	34	12.5%	10
Florida	16.2%	35	10.8%	41
Pennsylvania	16.1%	36	11.4%	26
Nevada	15.7%	38	10.8%	39
Illinois	15.4%	41	11.2%	28
Arizona	15.3%	43	11.0%	34
Massachusetts	15.2%	44	10.9%	36
Texas	15.0%	45	10.0%	46
Maryland	14.6%	48	11.1%	31
U.S. Average	**16.9%**		**11.6%**	

Source: U.S. Bureau of the Census and Bureau of Economic Analysis

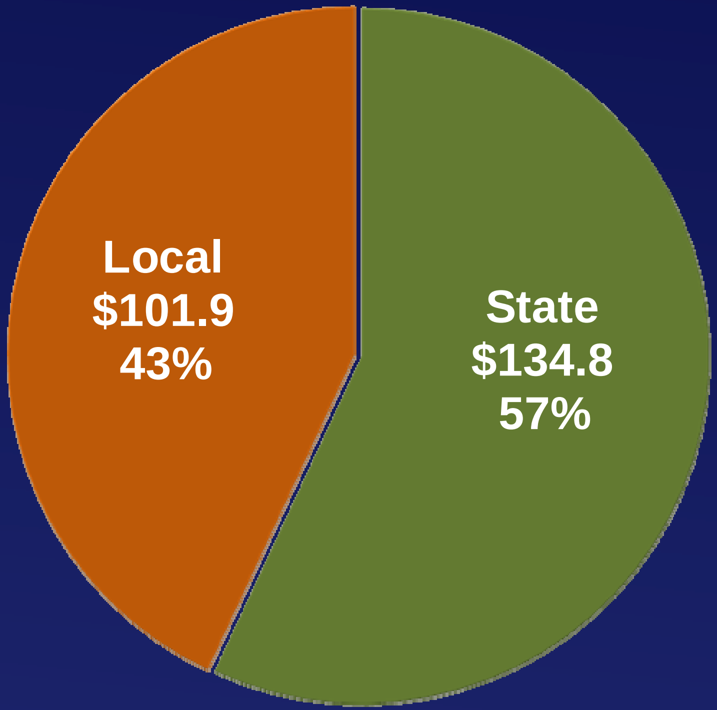
California State and Local Revenues 2005-06

(Dollars in billions)



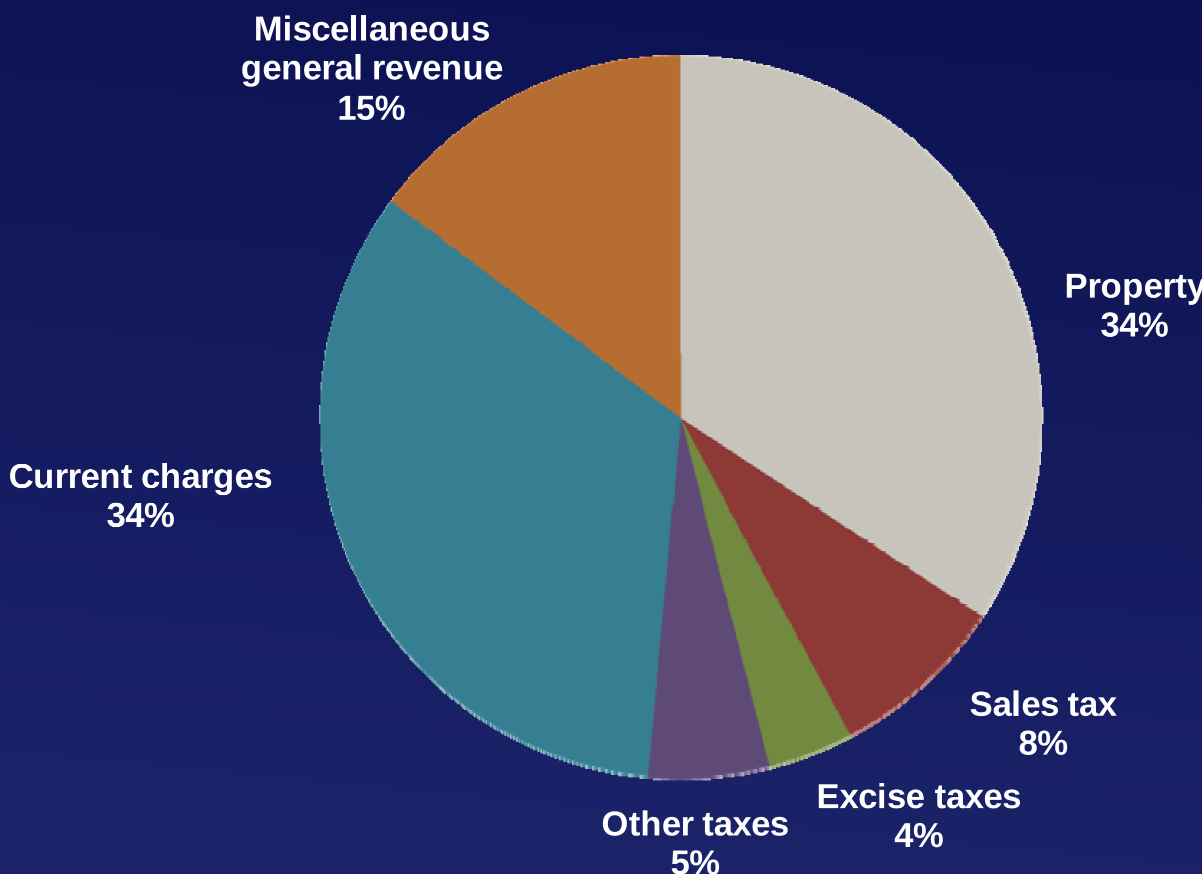
California State and Local Own Source Revenues 2005-06

(Dollars in billions)

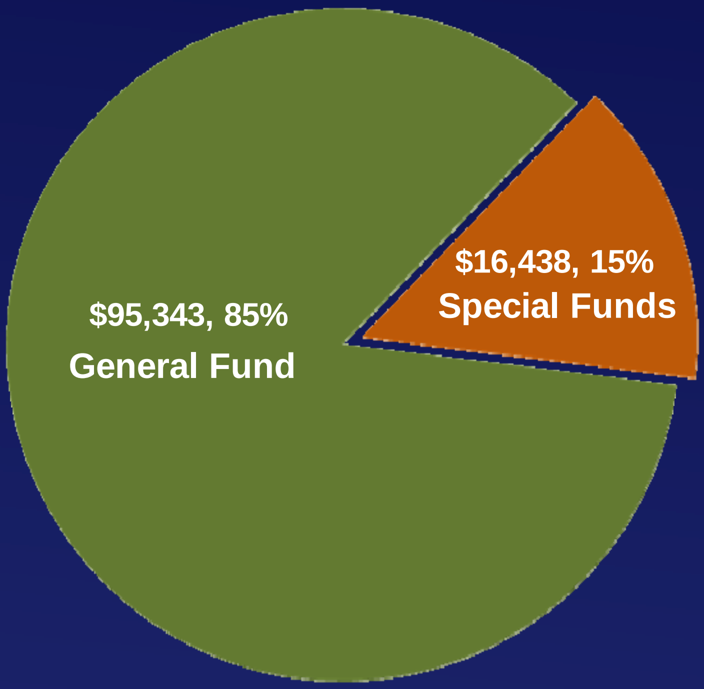


California Local Own Source Revenue

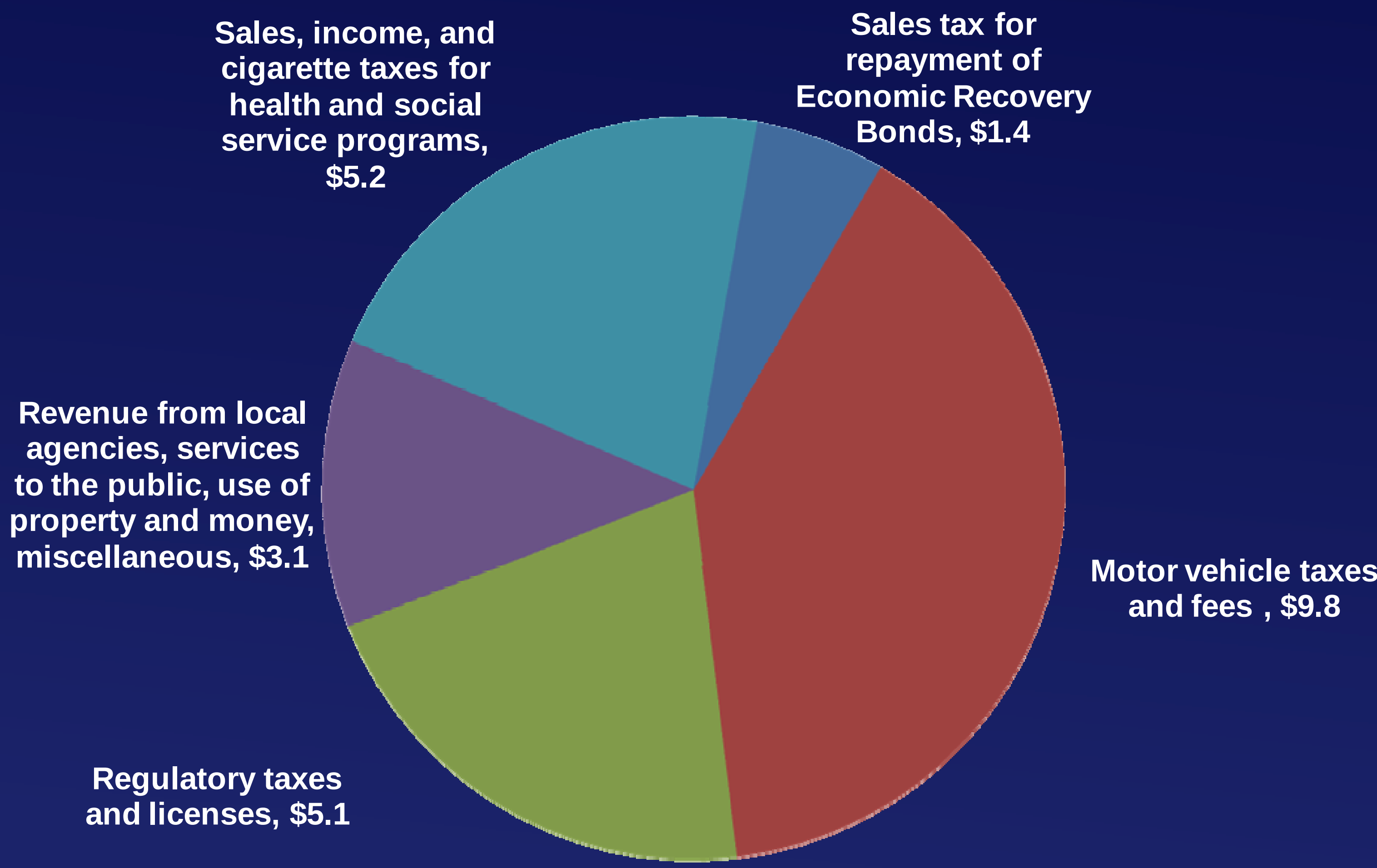
(Dollars in billions)



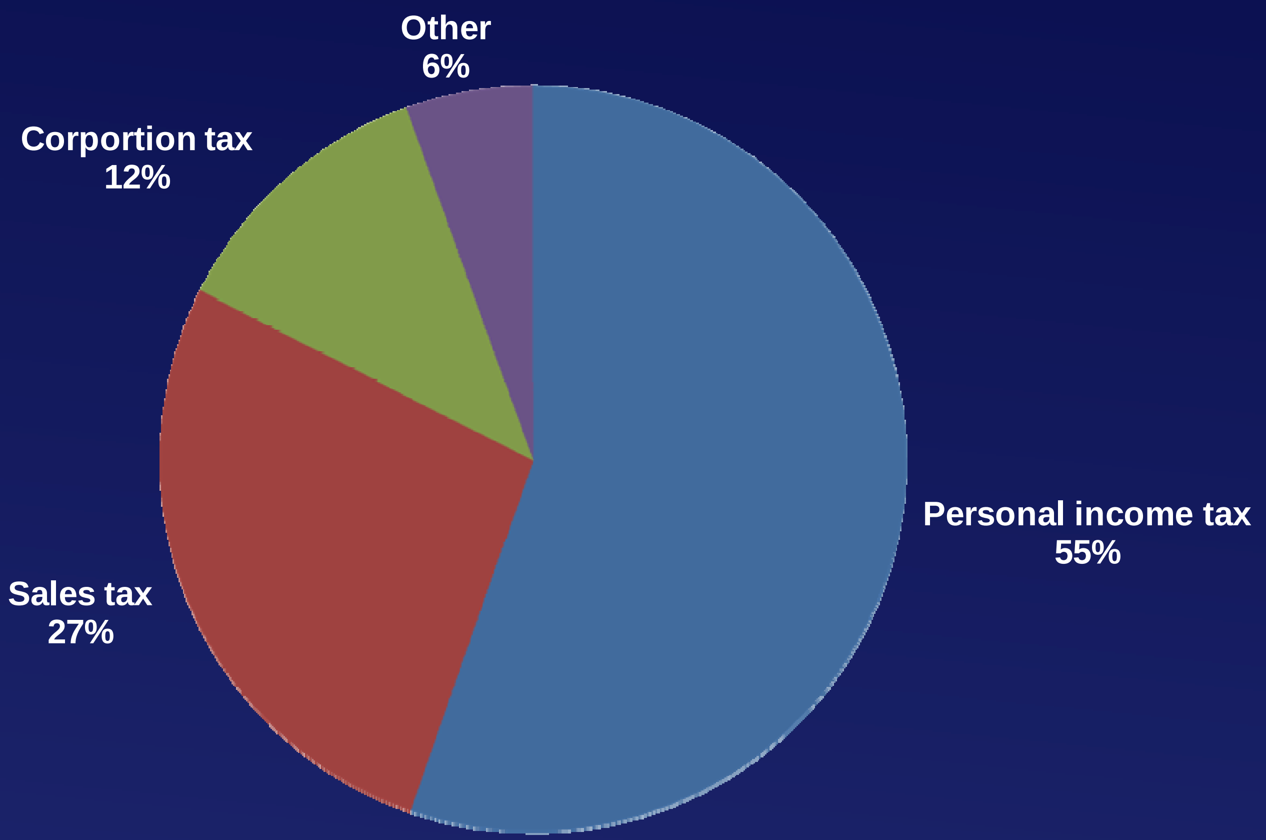
General Fund and Special Fund Revenues Share of Total 2007-08 State Tax Collections



State Special Fund Revenues 2007-08

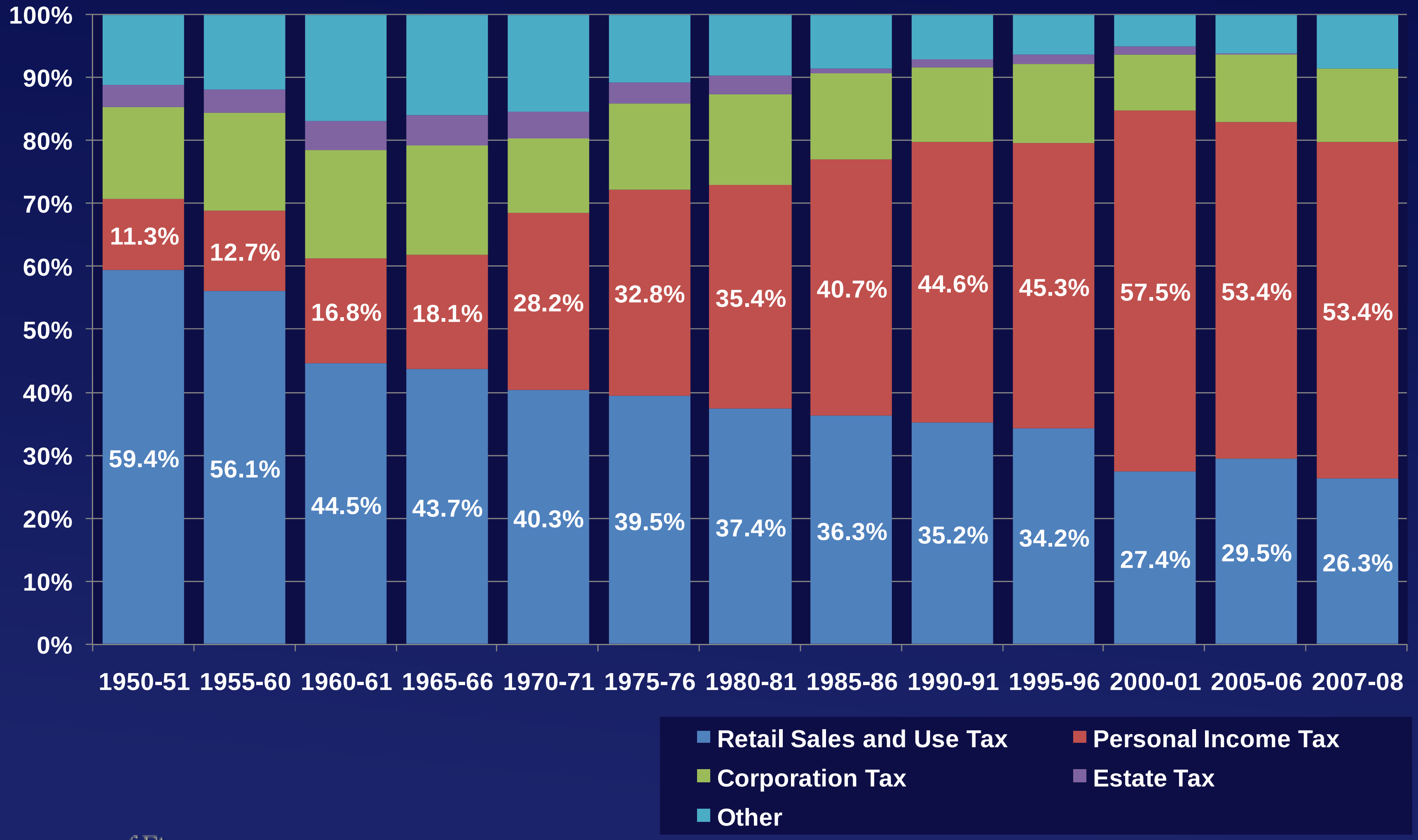


General Fund Revenue Sources 2007-08



California State Revenues by Source

($ Billions)



Progressivity

- Taxes may be described as progressive proportional, or regressive. A progressive tax is one in which the effective tax rate rises as income rises. A regressive tax is one in which the effective tax rate falls as income rises.
- The Personal income tax is progressive. Other state and local taxes tend to be regressive.

Largest State and Local Revenue Sources

- Sales and Use Taxes
- Personal Income Tax
- Corporation Tax
- Property Tax

Sales and Use Tax

- Sales tax is an excise that is imposed on retailers for the privilege of selling of tangible personal property in California.
- The use tax, a complement to the sales tax, is imposed on the storage, use or other consumption of tangible personal property purchased from a retailer not subject to the California sales tax; e.g., items purchased out-of-state for use in California such as mail order sales.
- Tax rates and exemptions are the same for both the sales tax and the use tax.

Sales and Use Tax Rates

7.25% Total Statewide Sales/Use Tax Rate

- 5.00% State General Fund
- 0.25% State Fiscal Recovery Fund (for repayment of Economic Recovery Bonds)
- 0.50% Local Revenue Fund (for health and social service programs)
- 0.50% Local Public Safety
- 0.75% City and County operations
- 0.25% County transportation

Up to 2% additional local sales tax rate, subject to voter approval

Total effective statewide sales tax rate is currently about 7.95%.

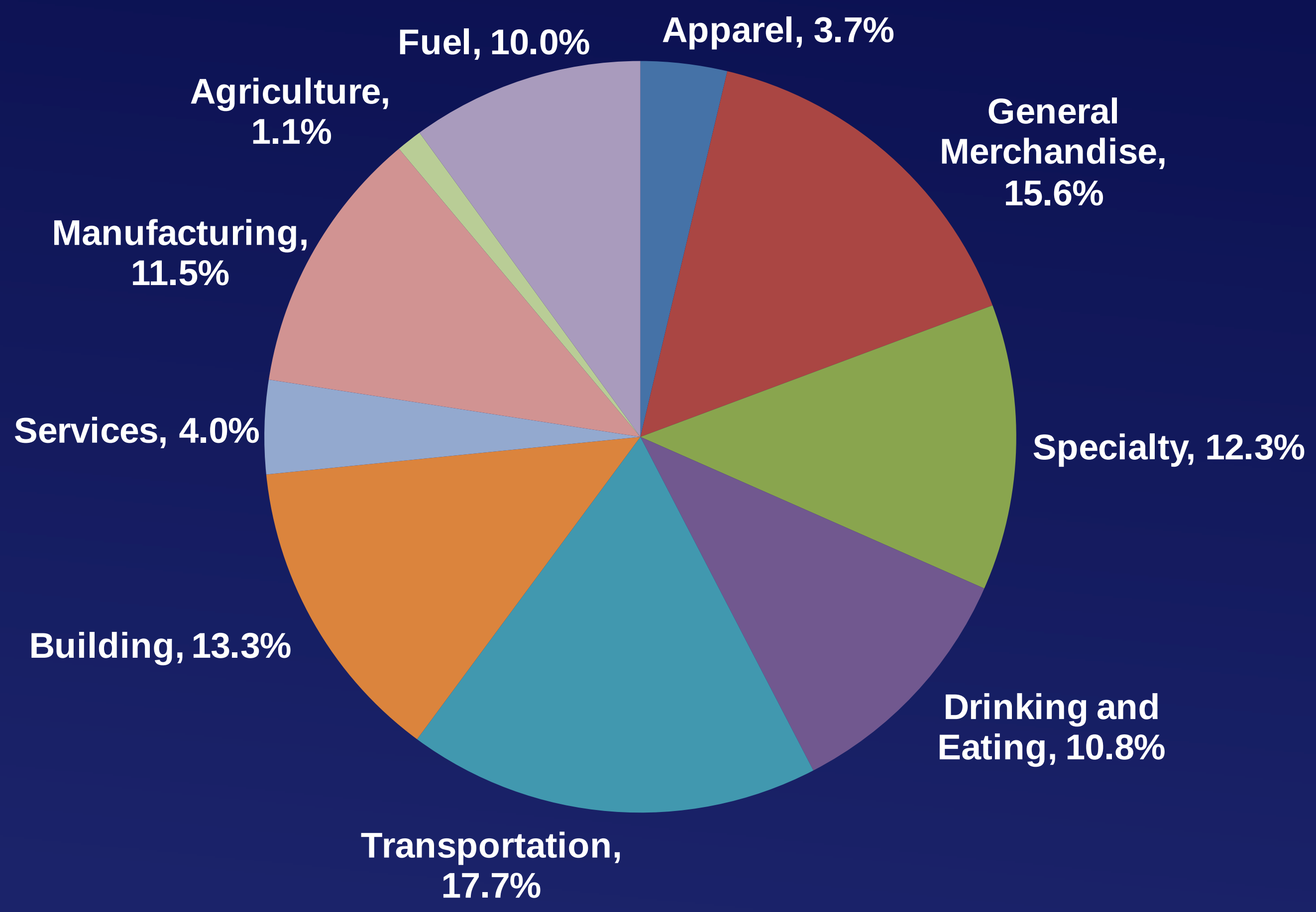
Sales and Use Tax Collection

- Compliance is much better for the sales tax than the use tax.
  - Sales tax—about 96%
  - Use tax—very low
- Retailers must have nexus with the state in order to be required to collect the sales tax.
  - Quill Corp. v. North Dakota, 5/26/92
- As mail order and Internet sales have grown, the state has lost a growing portion of its sales tax base.

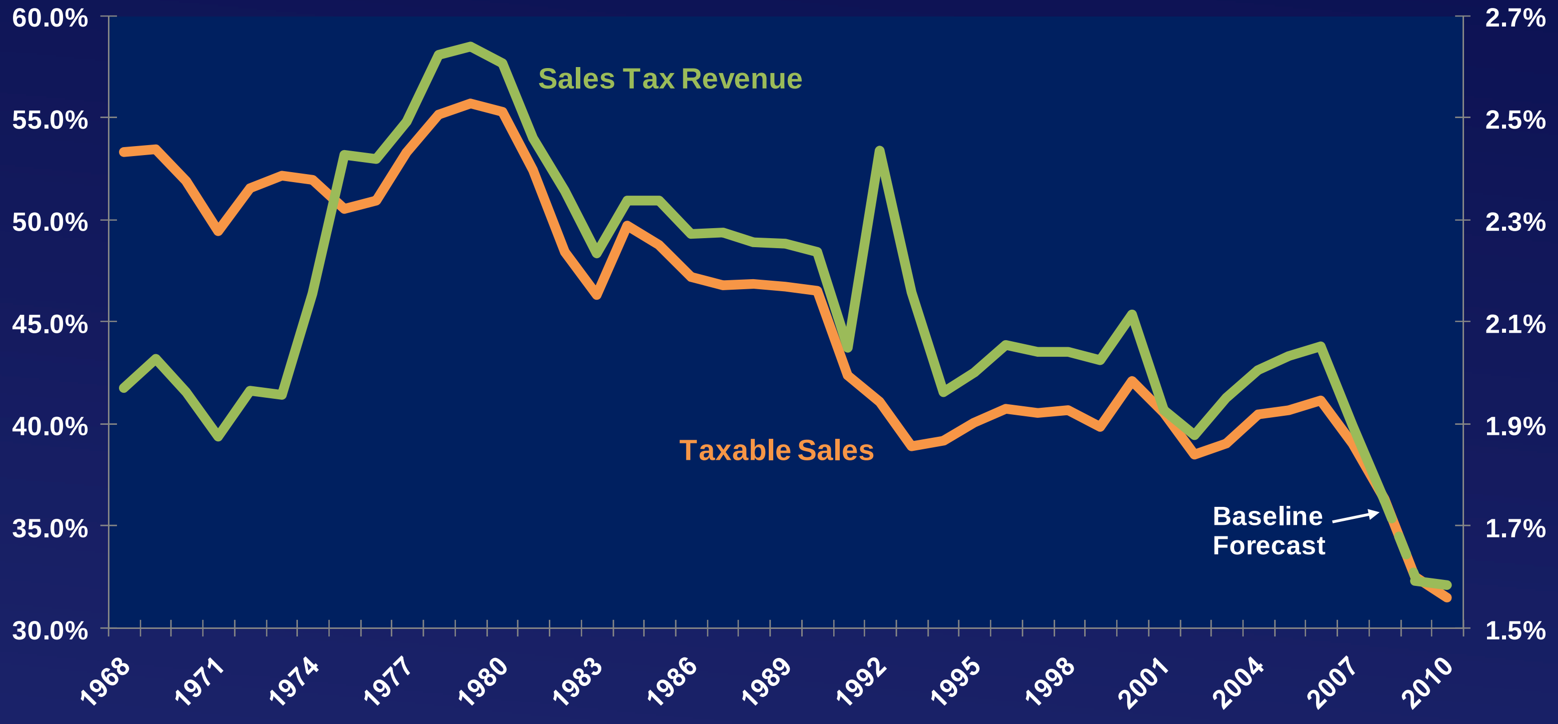
Taxation of Services

- California taxes few services relative to other states.
- A 2007 Federation of Tax Administrators survey shows that California taxes 21 services out of the 168 that were included in the survey.
- Only nine states in the survey taxed fewer services.

2007 Taxable Sales by Industry



Ratio of Taxable Sales and Sales Tax Revenue to Income



Sales and Use Tax Revenue
Fiscal Year Total and % Change

Department of Finance

Largest Sales and Use Tax Expenditures—2006-07 Revenue Loss

(Dollars in Millions)

Provision	State General Fund	Local	State Fiscal Recovery Fund
Food products	$3,992	$2,156	$200
Gas, electricity, water, and steam	2,161	1,167	108
Prescription medicines	1,691	913	85
Candy, confectionery, snack foods, and bottled water	382	206	19
Exemption for farm equipment	112	-	5
Fuel sold to common carriers	99	54	5
Rental of linen supplies	70	38	4
Custom computer programs	68	37	3
Diesel fuel used in farming and processing	41	-	2
Water common carriers	31	17	2

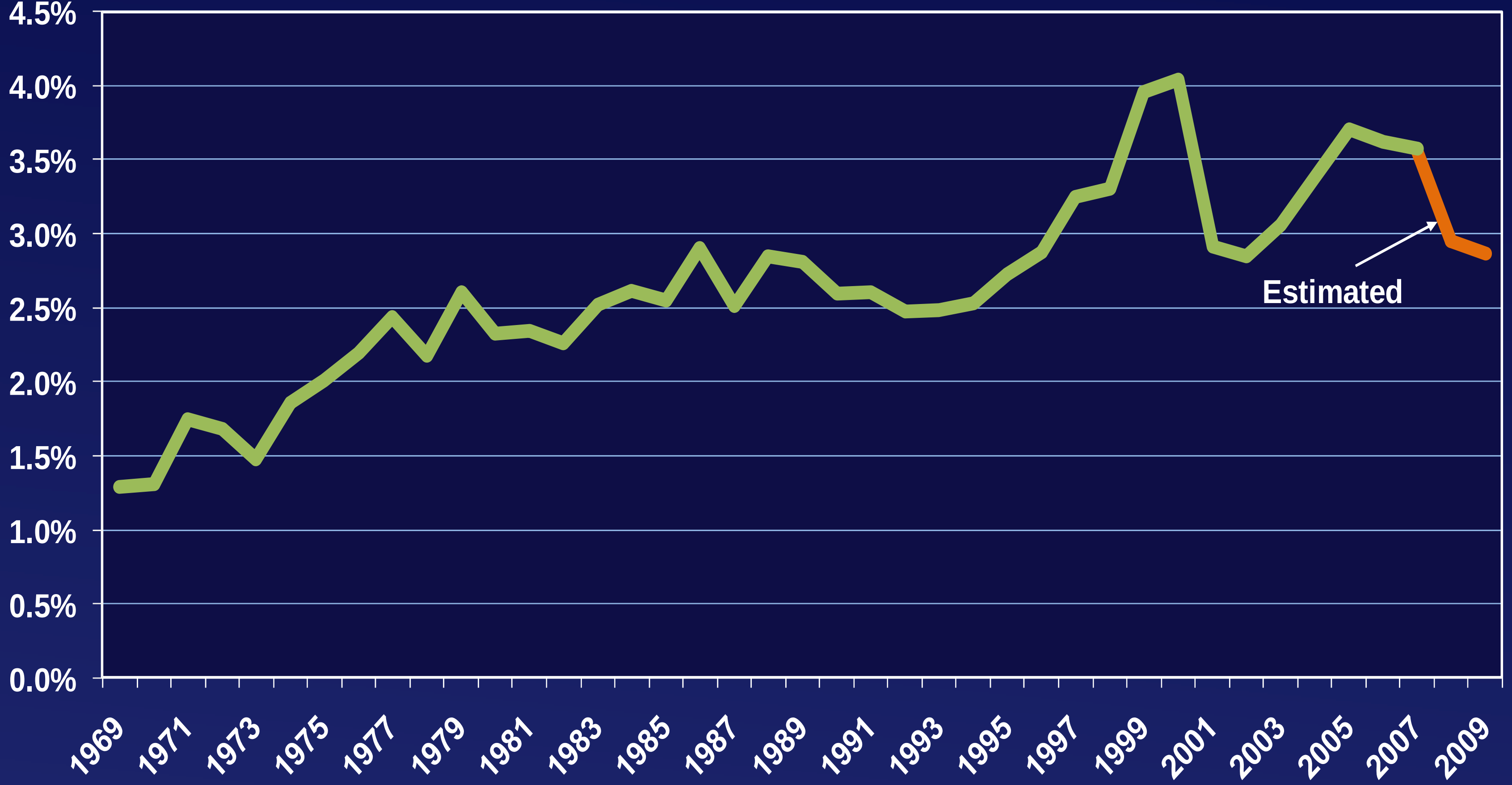
Some Options for Modifying the Sales and Use Tax

- Broaden the tax base to include more services.
- Eliminate the sales tax on business purchases.
- Explore methods to better collect use tax on remote sales.
- Explore methods to extend nexus to firms with substantial sales to customers in California.
- Supplement sales tax with a low tax rate gross receipts tax.
- Supplement or replace sales tax with value added tax.

Personal Income Tax

According to the Haig-Simon-Hicks (HSH) concept of income, income in a given period of time is the maximum amount that can be consumed in that period while keeping real wealth unchanged.

Ratio of Personal Income Tax to Personal Income



Personal Income Tax

- Modeled closely on the federal income tax
  - IRS is an important partner for enforcing compliance
  - Differences from federal laws add complexity and compliance burdens to taxpayers and tax administrators
- Major differences:
  - No preferential treatment of capital gains
  - Personal exemption credits, rather than deductions
  - No marriage penalty
- State personal income tax is deductable against the federal income tax for taxpayers who itemize their deductions

Personal Income Tax

- Start with federal adjusted gross income (AGI)
  - Wages, capital gains, dividends, interest, retirement income, flow-through income from businesses such as sole proprietorships, partnerships, limited liability companies (LLC), S-corporations…
- Less: Standard deduction or itemized deductions
- Less: Difference from federal AGI and itemized deductions
- Equals: Taxable income
- Times tax rates, equals: Tax before credits and alternative minimum tax (AMT)
- Less: Exemption and other credits
- Plus: AMT and other taxes
- Equals: Tax liability

Personal Income Tax

- Personal income tax contains 6 tax brackets, ranging from 1% for a joint tax return with taxable income (TI) under $14,336, to 9.3% for TI over $94,110.
- In addition, the Mental Health Services Tax Rate is 1% for TI in excess of $1 million. Revenues are used for county mental health services.
- As for federal law, the alternative minimum tax (AMT) is a parallel tax system with less generous accounting for income and lower deductions. The AMT rate is 7%.

Personal Income Tax is Progressive

2007 Personal Income Tax
Thresholds by Adjusted Gross Income

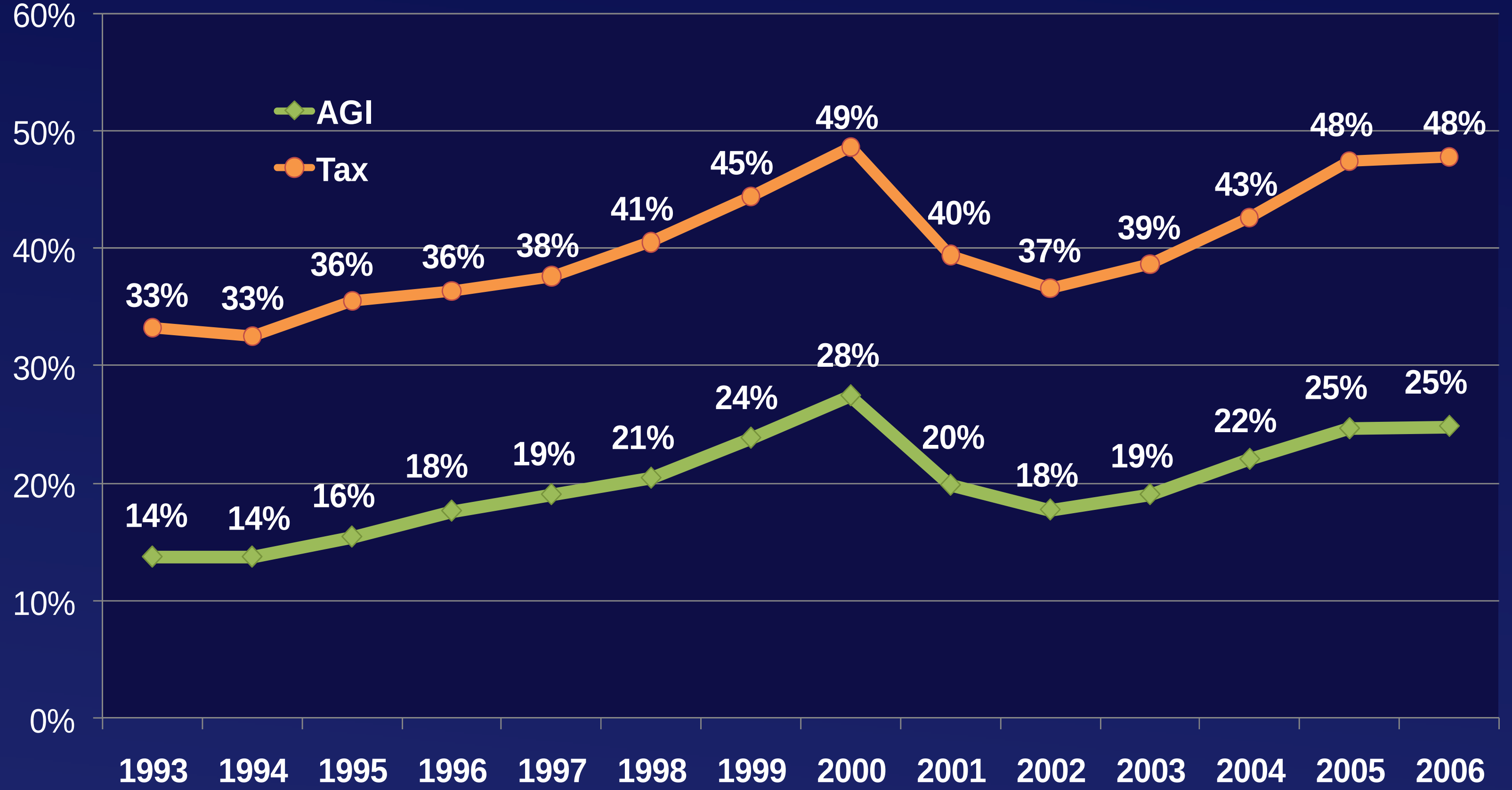
Filing Status	Without Renters' Credit	With Renters' Credit
Single	$11,667	$14,667
Married Couple With 2 Children	$46,083	$49,083
Head of household With 1 Child	$33,283	$39,283

Personal Income Tax Distributions of AGI and Tax

(2006 Tax Year)

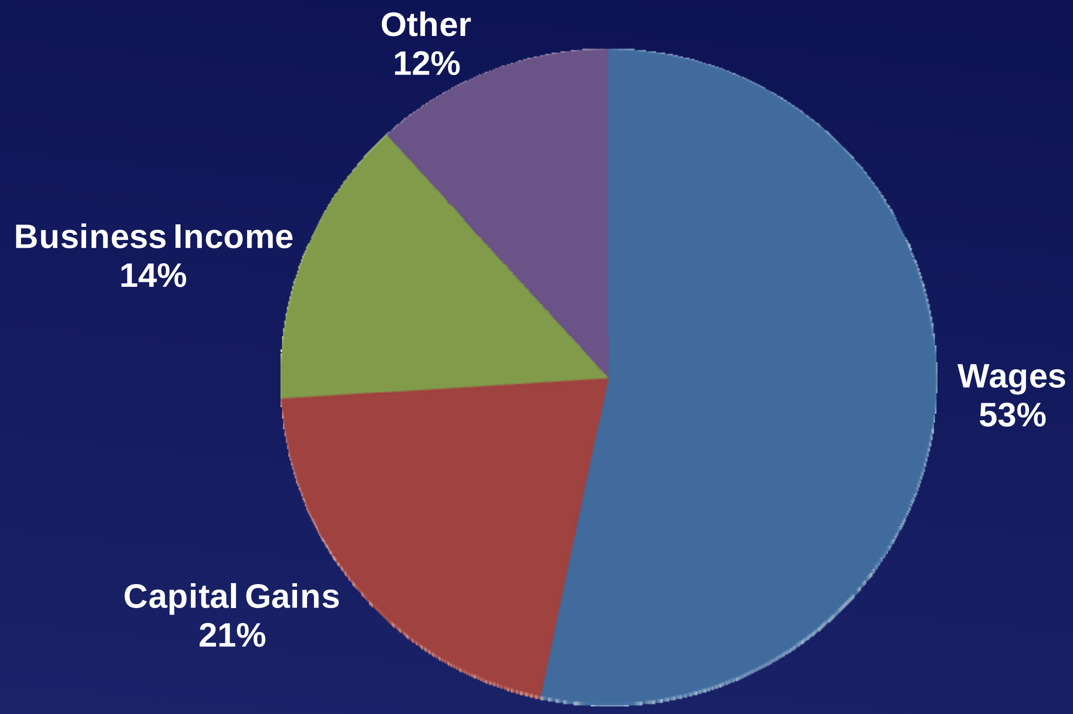
Interval	Returns (000)	Lower AGI of Internal	AGI in interval	Tax in Interval
Top 1%	144	$480,940	24.9%	47.9%
Top 5%	719	$178,185	39.8%	68.3%
Top 10%	1,438	$124,081	50.2%	78.5%
Top 20%	2,877	$82,684	64.3%	88.5%
4th 20%	2,877	$45,942	17.5%	8.4%
3rd 20%	2,877	$27,254	10.2%	2.5%
2nd 20%	2,877	$14,064	5.8%	0.5%
Bottom 20%	2,877	$0	2.1%	0.1%

Shares of AGI and Personal Income Tax Paid by Top 1% of Taxpayers



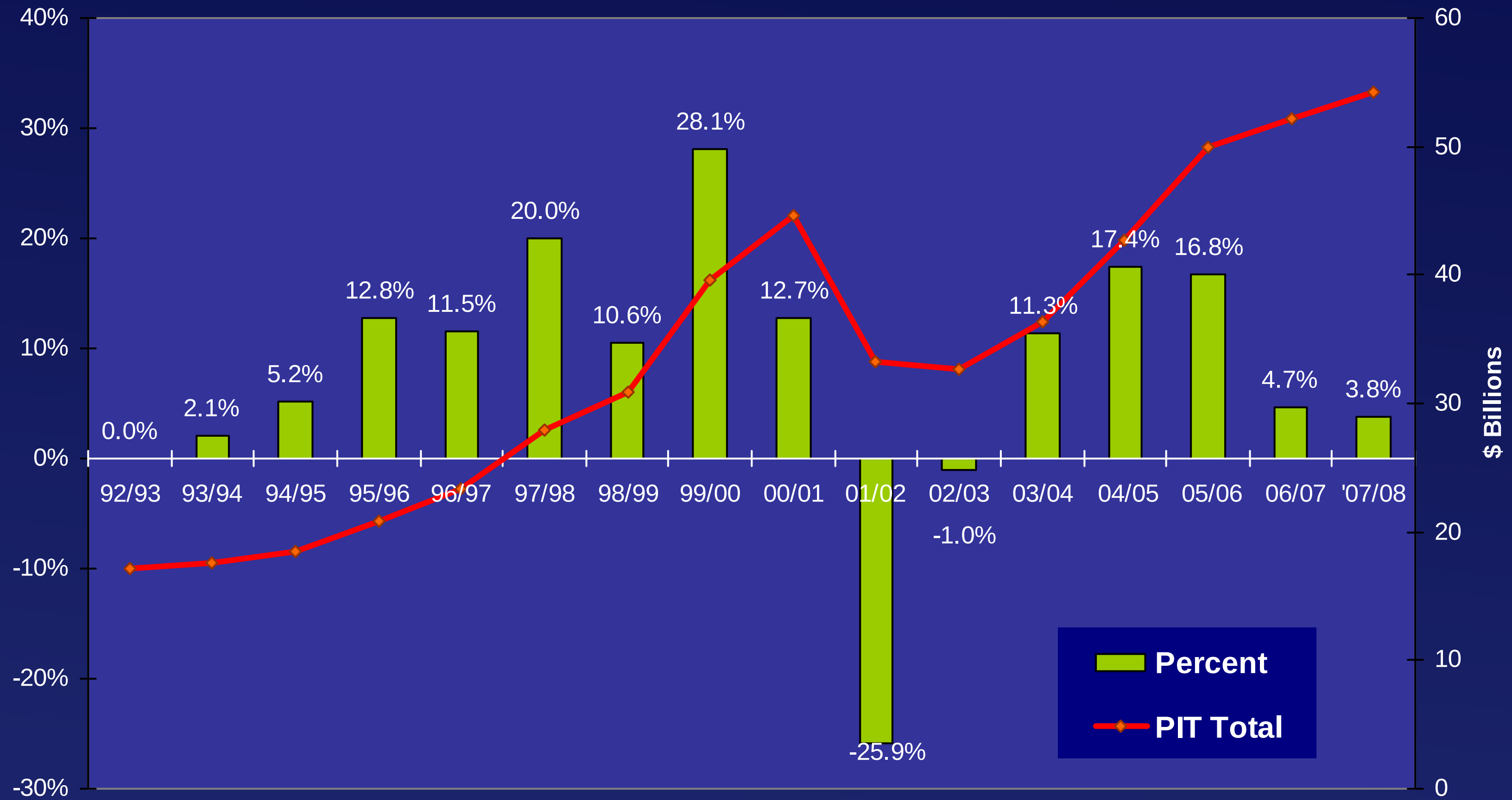
Tax Weighted Personal Income Tax AGI Components

(2006 Tax Year)



Income From Capital Gains
Tax Year Total and % Change

Personal Income Tax Revenue Fiscal Year Total and % Change



Largest Personal Income Tax Expenditures --2006-07 Revenue Loss

(Dollars in Millions)

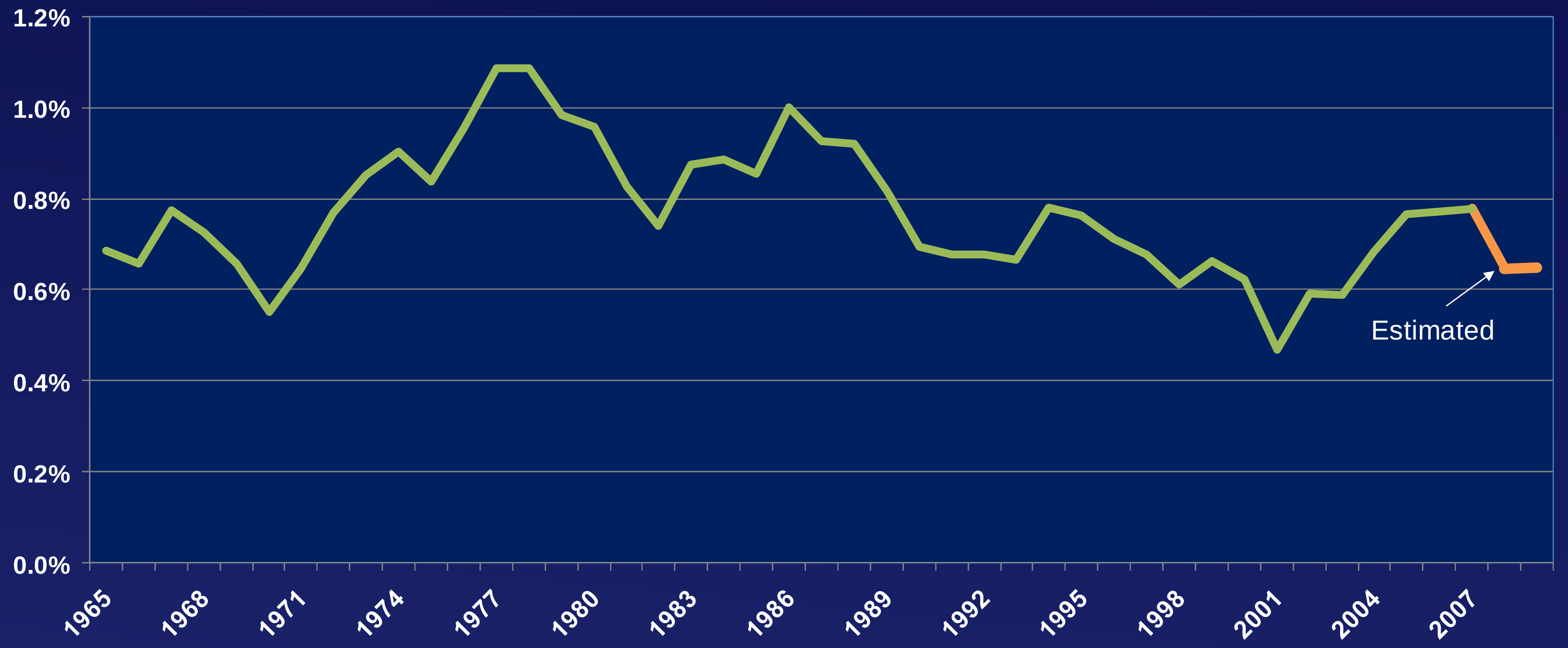
Provision	2006-07
Home mortgage interest deduction	$4,972
Exclusion of capital gains on sale of principal residence	4,161
Exclusion of employer pension contributions	4,094
Basis step-up on inherited property	3,892
Exclusion of employer contributions to health plans	2,898
Charitable contributions deduction/1	1,831
Exclusion of Social Security benefits	1,636
Real estate deduction	1,327
Dependent exemption in excess of personal exemption credit	1,283
Exclusion of benefits provided under cafeteria plans	1,130
Exclusion of investment income on life insurance and annuity contracts	1,076
Employee business and miscellaneous expenses deduction	765
Head-of-household and qualifying widower filing status	690
Contributions to IRAs deduction	537

Some Options for Modifying the Personal Income Tax

- Piggyback on federal income tax
- Broaden the tax base
- Revise the tax rates
- Revise taxation of business income
- Replace the personal income tax and the corporation franchise and income tax with a value added tax

Corporation Franchise and Income Tax

Ratio of Corporation Tax to Personal Income



Corporate Franchise and Income Tax

- Most corporations are subject to the California Corporate Franchise Tax
- The Corporate Franchise tax is not an income tax, but a privilege tax, measured by income
  - Unlike a state income tax, interest on U.S. obligations, such as from U.S. bonds and Treasury notes is taxable
- California requires unitary reporting of business income
  - Incomes of all commonly owned and controlled corporations generally need to be combined and reported in combined reports
  - Combined reports include all multistate and multinational unitary corporations, including corporations with no nexus to California
  - However, combined groups may file “waters edge” elections to exclude non-U.S. corporations

Corporation Tax Calcualtion

Gross income

Minus cost of goods sold, plus other income = Total income

Minus deductions, such as depreciation = Federal taxable income

Plus California adjustments, such as depreciation in excess of amount California allows, minus CA adjustments, such as inter-company dividend deduction = Total net income or loss

For multistate or multinational corporations, apportion California's share of unitary income, and allocate nonbusiness income = California taxable income

Multiply income by tax rate

Minus tax credits and add alternative minimum tax = Total tax liability

Apportionment

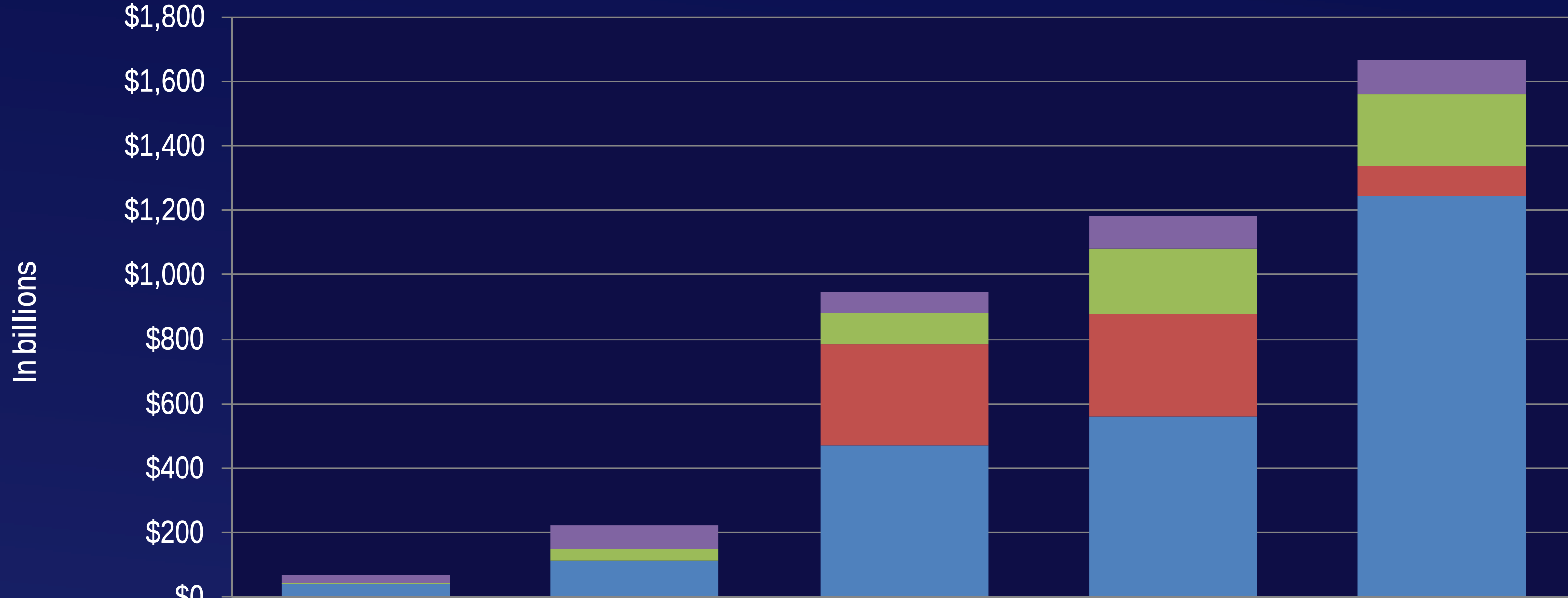
- Uniform Division of Income for Tax purposes Act (UDIPTA)
  - Formulary method to source income across states
  - Enacted in 1957
  - Three-factor formula
    - Sales
    - Property
    - Payroll
  - Example: A corporation with 10% sales, 70% property, and 70% payroll within the state would apportion 50% of its business income to the state
    - $\frac{10\% + 70\% + 70\%}{3} = \frac{150\%}{3} = 50\%$
  - Since adopted, considerable variation in apportionment formulas across states:
    - 10 states use a three-factor formula
    - 20 states use a four-factor-double-weighted-sales formula
    - 13 states use a single-factor formula, and
    - The remaining 7 states either don't tax corporate income, or use a different apportionment method

Apportionment

- In 2003, California switched to a four-factor double-weighted-sales formula
  - Using percentages from the example above, income apportionment for the same corporation would be 40%
    - $\frac{2 * 10\% + 70\% + 70\%}{4} = \frac{160\%}{4} = 40\%$
- For single-factor-sales apportionment, only 10% of business income would be apportioned to the state
- Net exporting corporations benefit from higher sales factor weights
  - But, there are many winners and losers, and
  - The logical premise of apportionment is weakened
    - For single-factor-sales apportionment, no economic theory supports sourcing value to the point of sales, with no consideration to the point of production
    - United States Constitution Commerce Clause risk

Corporation Tax Credits

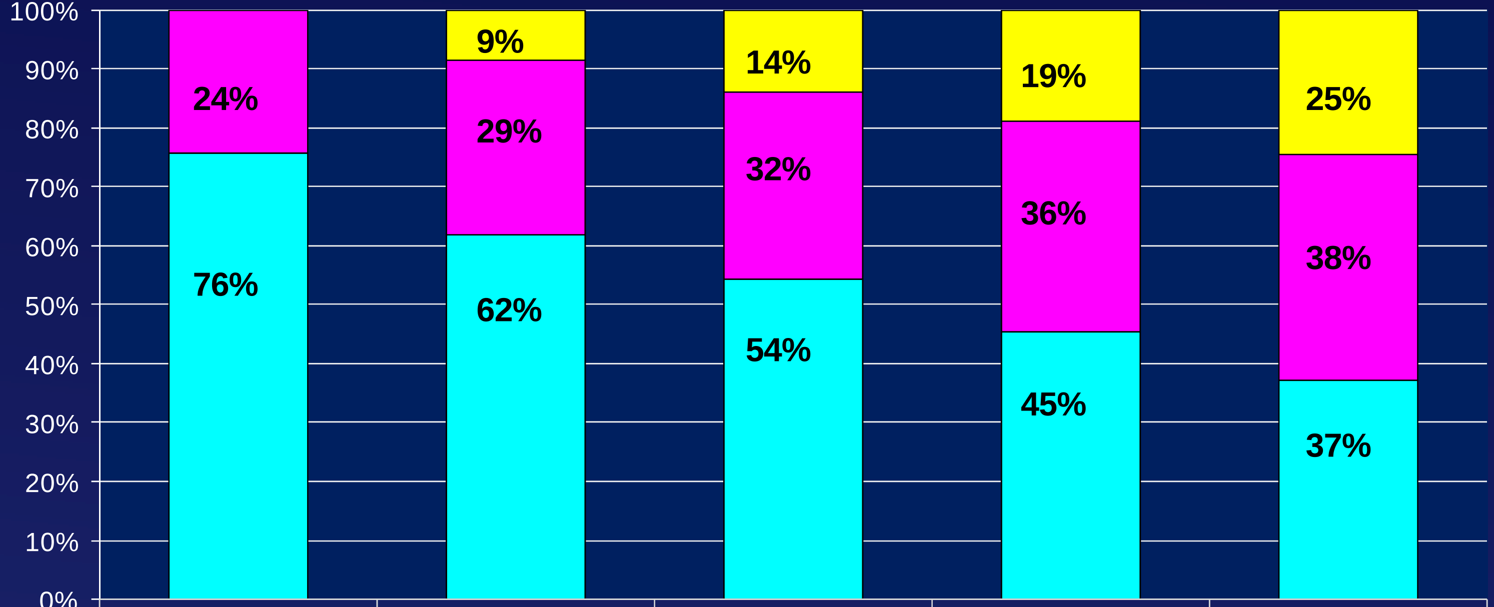
(Dollars in Millions)



	1988	1993	1998	2003	2006
Other	$23	$72	$63	$101	$105
Economic Development	$2	$38	$97	$203	227
Manufacturing	$0	$0	$316	$316	$91
Research	$39	$110	$467	$559	$1,243

Tax Year

Number of C-Corporations, S-Corporations, LLCs
(In thousands)



	1993	1998	2000	2003	2006
LLCs	0	44	80	138	221
S-Corporations	102	149	184	260	347
C-Corporations	316	312	314	329	333

Largest Corporation Tax Expenditures—2006-07 Revenue Loss

(Dollars in Millions)

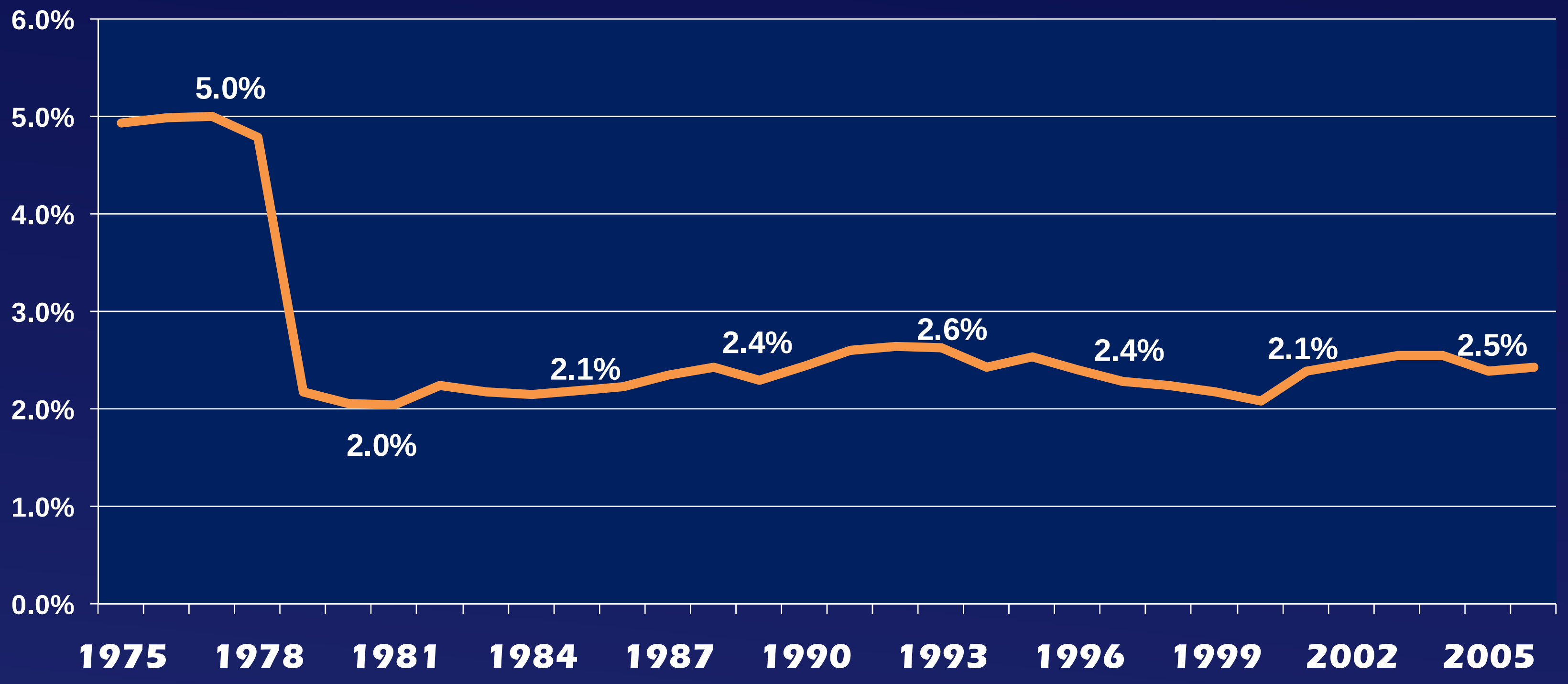
Provision	2006-07
Research and development credit	$1,151
Water's edge election	670
Subchapter S corporations	350
Special treatment for economically depressed areas	450
Double-weighted sales factor	235
Corporations exempt from minimum tax	116
Charitable contributions deduction	109
Like-kind Exchanges	150
Accelerated depreciation of research and experimental costs	50
Low-income housing credit	53
Employee stock ownership plans	38
Percentage depletion of mineral and other natural resources	24

Some Options for Modifying the Corporation Tax

- Revise income apportionment methods and formulas
- Tax all pass-through entities to whom California grants limited liability similarly
- Replace the personal income tax and the corporation tax with a value added tax

Property Tax

Ratio of Property Tax to Personal Income



Note: 2000-01 and 2002-03 are **estimated**.

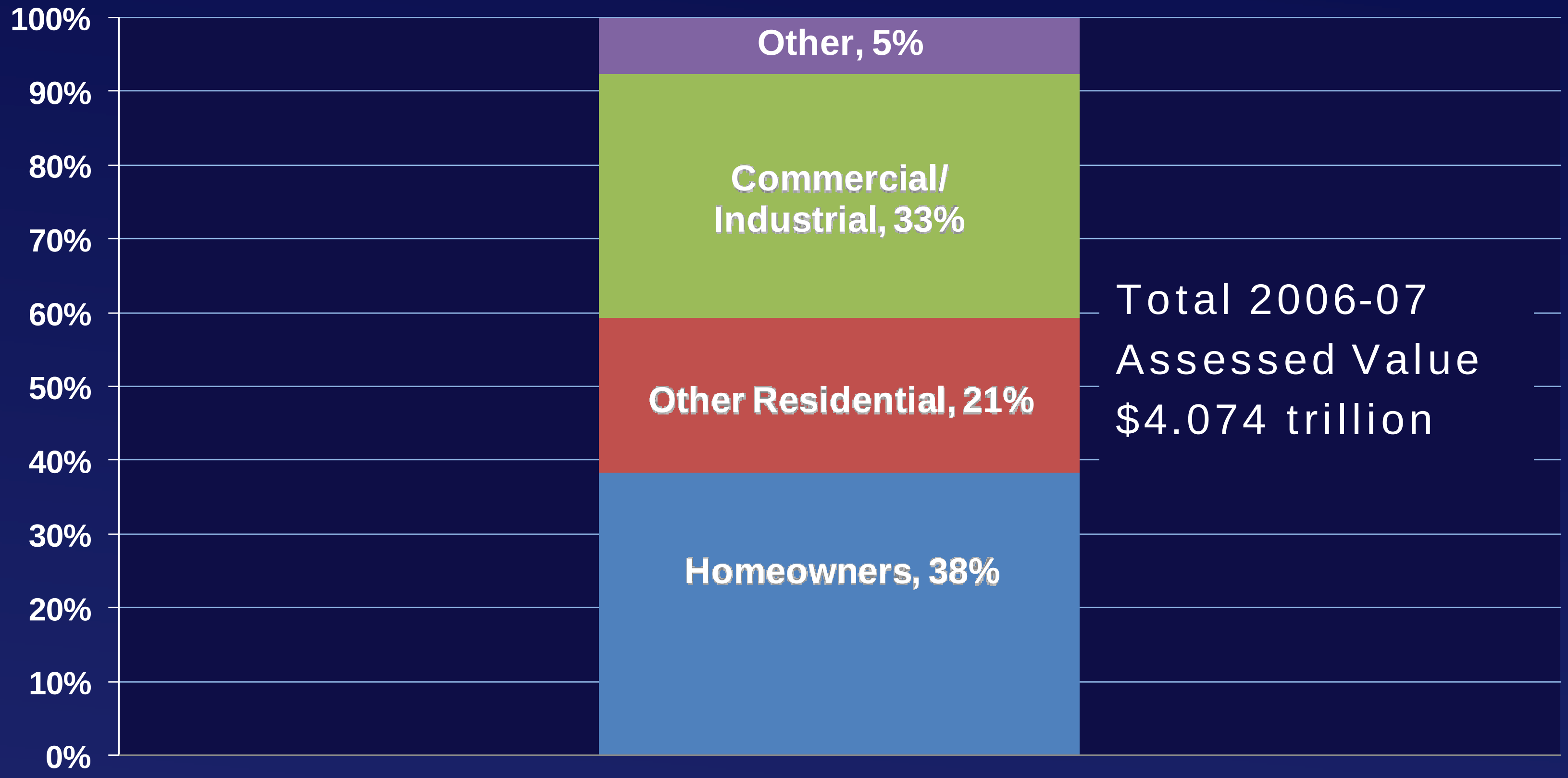
Property Tax

- Prior to the passage of Proposition 13 in 1978
  - Property valuation was based on the market value of property
  - Property tax rates were set by each local entity (with certain limitations), with an average rate of about 3%.
- Since 1978, real property has generally been taxed based on its value when purchased or newly constructed
- Annual increases for inflation from the base year are limited to 2% per year.
- The property tax rate is capped:
  - The base countywide rate is limited to a maximum of 1%
  - Local agencies can levy additional rates to pay principal and interest on voter-approved debt.
  - The statewide average rate in 2006-07 was 1.099%.

Property Tax Valuation

- Re-valuation of property occurs when there is a change in ownership or new construction.
- Under state law, a change of ownership in business property occurs when one company takes ownership of more than 50% of another.
  - Over 50% of the shares of a publicly traded company can change hands without triggering reassessment, as long as no one company acquires more than 50% of the shares.
  - If property is sold with no one owner receiving more than 50% of the total interest in the property, no reassessment occurs.
- When new construction occurs on only a portion of a property, only the newly constructed portion is given a new value.
- Property that declines in value below it's base year value adjusted for inflation is reassessed to reflect the lower value.

Property Tax Assessed Values



Some Options for Modifying the Property Tax

- Split roll
- Modify reassessment rules for change in ownership
- Increase maximum assessment increase from 2% to 3%, 4%, or 5%