Considerations regarding the state "piggybacking" onto the federal income tax system

Background:

The calculation of California personal income tax begins with federal adjusted gross income. Adjustments are then made to federal AGI to determine California taxable income and tax liability. Some observers have recommended using federal taxable income or federal tax liability as the starting point for calculating California tax liability.

There are both policy and administrative issues with a California income tax system that "piggybacks" onto the federal one.

Major Issues:

<u>Piggybacking would reduce volatility somewhat and spread the tax burden more broadly</u>. At least in recent economic cycles, incomes from capital gains and dividends have been more volatile than income from other sources. By shifting more of the tax base to less volatile sources and broadening the base by extending tax to lower income levels with a somewhat less progressive set of brackets, California would likely have lower peaks and higher valleys.

<u>Piggybacking would probably reduce the growth rate of Personal Income Tax receipts.</u> In recent years, incomes from capital gains and dividends have grown more rapidly, including the stock market bubble collapse years, than other incomes. A marked difference in income growth between the very rich and all others has been noted in recent years in many economic analyses. This appears to be an effect of a shift to global production where labor values are suppressed due to an increasing supply and due to the efficiencies provided by technology that make owning production capital more rewarding. These trends seem unlikely to reverse unless vigorous protectionist political action is taken at the national level or federal tax policy changes (see below).

<u>Piggybacking on federal tax requires higher stated tax rates to maintain revenue neutrality</u> because the tax base is smaller due to the reduced federal rate on capital gains and dividends and the itemized deduction for state and local taxes. If California tax liability equals 32.2 percent of federal liability -- an example of the rate needed to maintain revenue neutrality under one set of assumptions – then the top rate would be 11.3 percent (32.2% state rate x 35% federal rate) instead of the current 9.3 percent. (Proposition 63 imposes an additional 1% tax on taxable incomes above $1 million.)

<u>Changing rates and what is subject to tax creates winners and losers across income groups and by types of income.</u> For example, taxpayers with substantial capital gains will pay less, but taxpayers with pass-through income – e.g., Subchapter S income – will pay more tax because marginal rates are higher. In general, tax rates on investment income would go down while tax rates on business income and wages would go up.

Based on old FTB estimates, the table below illustrates the average tax change for different income groups if all taxpayers pay the same percentage of their federal income tax in California income tax. The rate used was 32.2 percent of federal liability.

Adjusted gross income	Average tax change	Percentage change
under $20,000	$ 37 increase	193%
20 - 40,000	$ 201 increase	78
40 - 80,000	$ 298 increase	27
80 - 160,000	$ 167 decrease	-4
160 - 320,000	$ 987 decrease	-8
320 - 640,000	$ 1,386 decrease	-5
640 -1,280,000	$ 2,317 decrease	-4
1,280,000 & above	$19,683 decrease	-8

An alternative to a single piggyback rate is graduated rates. This would generally reduce the amount of tax increase or decrease within income groups. The table below illustrates the average tax change at different income levels if rates are graduated from 8.5 percent of federal tax for taxpayers with income of less than $20,000 to 36.3 percent of federal tax for taxpayers with income of $100,000 or more. (Note: The AGI amounts in the two tables differ; they are drawn from different data requests made to FTB.)

Adjusted gross income	Average tax change	Percentage change
under $20,000	Less than $1	3 %
20 - 40,000	$ 4 decrease	-2
40 - 75,000	$ 7 increase	1
75 - 200,000	$ 217 increase	5
200 - 500,000	$ 207 increase	1
500 - 1,000,000	$ 96 increase	0
1,000,000 & above	$16,021 decrease	-6

<u>Complex transition rules will be needed to avoid economic distortions</u> – e.g., taxpayers with net operating losses carried forward from prior years are likely to have more NOLs for state tax purposes than for federal purposes. Piggybacking onto federal liability would wipe out some state NOLs unless transition rules are provided. It will take considerable time to make decisions about these and draft statutory language.

<u>Basing state tax on federal taxes paid may increase revenue volatility rather than reduce it due to changes in Federal tax policy.</u> This appears to be the primary reason why all of the states that have tried this approach have now abandoned it. To avoid this outcome, a mechanism could be included in the proposal that provides a realistic opportunity to adjust the state rate to neutralize federal policy changes. One way to help this would be to have state tax look back to a prior year federal liability, e.g. your 2007 state tax would be based on your 2006 federal liability.

If the goal is to reduce volatility by reducing reliance on capital gains as a revenue source and broadening the tax base, this can be achieved more directly by imposing a lower tax on capital gains, reducing or eliminating credits for dependents, child care, and renters, increasing marginal rates, or reducing tax brackets. The examples below illustrate how federal tax actions could impact state revenues and the budget:

The Governor proposes piggybacking on federal income tax as part of his 2007-08 budget. The Legislature passes the piggybacking proposal as part of the budget package, setting the 2007 rate at 33 percent of federal liability.

Example 1: prospective federal tax changes
In October 2007, Congress enacts, and the President signs, legislation eliminating the Alternative Minimum Tax and reinstating the estate tax beginning in 2008. This reduces the amount of federal income tax liability on which 2008 California income tax is calculated. Although the state gains some revenue from the "pick-up" estate tax, it is not enough to make up for the loss of revenue from AMT. For his 2008-09 budget, the Governor must propose cutting spending or increasing the 33 percent rate or some other tax. This would require a two-thirds vote of the Legislature.

Example 2: "retroactive" federal tax changes
Same as Example 1, except Congress makes the change effective for the 2007 tax year. To balance the 2007-08 enacted budget, the Governor must either call the Legislature back into session to raise the income tax rate for 2007, propose mid-year cuts in January 2008, or propose a greater increase in the rate for 2008 to make up for the deficit in 2007-08.

Changes in federal tax law are likely in future years due to the large federal deficit, the sunsetting of several current tax breaks, including the 15% rate on capital gains, and the need to do something about the growing bite of the federal AMT. State AMT thresholds are indexed so we do not have the same problem the federal government is facing.

The state can't tax certain income even though it is subject to federal tax unless there's a change in federal law and/or the State Constitution. Examples include:

Interest on certain federal debt – e.g., Fannie Maes
Railroad retirement income
California lottery winnings
Certain Indian reservation income

To adjust for these differences, the California return would need to include space for affected taxpayers to recalculate their federal taxes excluding these types of income.

Recommendation:

In order to fully evaluate a piggybacking proposal, the following decisions need to be made:

1. Do you want to base California tax on a percentage of federal taxable income or a percentage of federal tax? Federal tax picks up the reduced tax on capital gains and dividend income as well as the marriage penalty.

2. If you choose federal tax, do you want to include the AMT tax? The federal AMT generates $3.8 billion from California taxpayers, while the current state AMT generates $39 million. Relieving middle income taxpayers of AMT liability has been an ongoing concern at the federal level.

3. If you choose federal tax, do you want to base the California tax on federal taxes owed before or after federal tax credits are applied? Federal tax credits include:

Adoption
Child care
Earned income ($4.6 billion of which $3.9 billion is refunded)
Electric vehicles

Foreign taxes
Research
Tuition

4. Do you want to allow state tax credits to reduce tax liability? State tax credits include:

Personal/dependent	$ 4.2 billion	(federal uses deduction)
Renters	$ 97 million	(no comparable federal credit)
Child care	$210 million	(similar federal credit, but not refundable)
Research	$ 31 million	(similar federal credit, but rate is higher)

Or alternately do you want to fund direct subsidies to replace any of these tax credits and raise the rate enough to pay for them?

5. Do you want one tax rate or graduated rates? Graduated rates reduce the shift in tax burden, but aggravate the tax increase on business income.

6. Do you want to include a provision for automatically increasing or reducing the tax rate(s) to maintain "revenue neutrality"?– e.g., give FTB or a new Commission authority to change rates when federal law changes. Alternately, do you want to include the tax rate change in the Budget Bill? There could be constitutional and practical difficulties with either approach.

7. Do you want to exempt certain types of income – e.g., Social Security, unemployment which are currently not taxed?

8. Do you want to provide for transitional rules when there's been a difference between federal and state treatment of income and expenses – e.g., depreciation, NOLs, research and development credits?