California's Tax System

A Primer

Elizabeth G. Hill, Legislative Analyst • January 2001

Personal Income Tax

Corporate Taxes

Sales and Use Tax

Excise Taxes

Property Tax

Acknowledgments

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Introduction

California has over 35 million residents, is the sixth largest economy in the world, exhibits tremendous economic and demographic variation, and has substantial and diverse demands in such areas as education, health care, and infrastructure. It is not surprising, therefore, that its public sector is one of the largest and most diversified in the world. Like most governments, California relies primarily on taxes to fund the public services that it provides to its individuals and businesses. California's state and local governments raise in excess of $120 billion annually in own-source revenues to provide public services, with roughly 70 percent of this from taxes.

What are the different types of taxes upon which California relies? What is their relative importance, and how have they evolved over time? How large a "burden" do these taxes impose on Californians, both in absolute terms and compared to other states, and how is this burden distributed? What types of policy issues are associated with the current tax structure, especially in light of our changing economy? The purpose of this primer is to address these and other tax-related questions, so as to aid policymakers and other interested parties in their tax-related deliberations and decision making.

The primer is organized into the following six sections: (1) overview of California's tax structure, (2) the personal income tax, (3) the sales and use tax, (4) corporate taxation; (5) other state taxes, and (6) local taxation. Also included is a glossary of common tax terms.

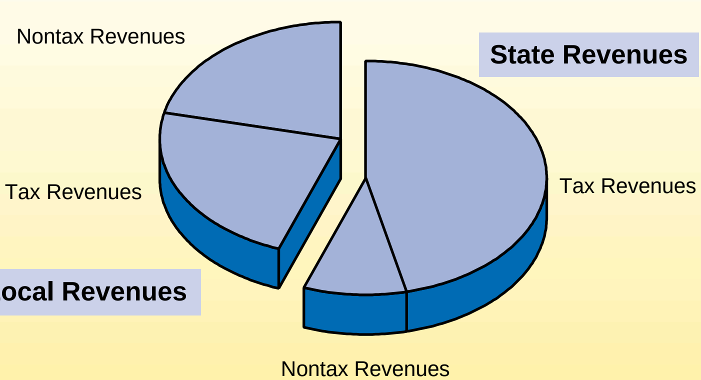
Overview of California's Tax System

Taxes Pay for Most of California's Public Services

Taxes play a vital role in California's state and local fiscal system. In 1995-96 (the last year for which comprehensive data are available), over $150 billion was spent annually to provide public services to California's residents and businesses. Of this total, about $30 billion came from the federal government while the remaining $120 billion was financed through own-source state and local government revenues. Of own-source revenues, roughly 55 percent is typically raised by the state and 45 percent by localities. In turn, taxes account for three-quarters of the state share and one-half of the local share.

Tax and Nontax Shares of State and Local Revenues

1995-96



What Taxes Are Levied in California?

State Taxes

Approximately 90 percent of the state's own-source revenue comes from four sources: the personal income tax (PIT), the sales and use tax (SUT), the bank and corporation tax, and major motor vehicle-related levies.

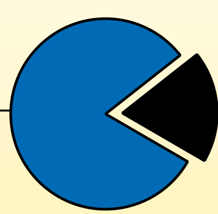
- The first three largely finance the state's General Fund, which supports about 80 percent of all state spending. By far the largest single tax is the PIT, accounting for over half of all General Fund revenues.
- The remaining 20 percent of state spending is from special funds for designated purposes, including over half for transportation funded by motor vehicle-related levies. Certain tobacco-related taxes and sales taxes also go into special funds to support health programs and local governments, respectively.

Total State Revenues

2000-01 (In Billions)

Total State Revenues $90.4 Billion

General Fund Revenues		Special Funds Revenues	
Personal Income Tax	$41.3	Motor Vehicle-Related Levies	$8.4
Sales and Use Tax	21.3	Sales and Use Tax[a]	2.9
Bank and Corporation Tax	6.8	Tobacco-Related Taxes	1.1
All Other[b]	4.5	All Other[b]	4.1
Total	**$73.9**	**Total**	**$16.5**



[a] Consists of amounts for Local Revenue Fund and transportation-related purposes. Excludes $2.2 billion allocated to Local Public Safety Fund, which is not shown in the budget totals.

[b] Includes transfers and loans.

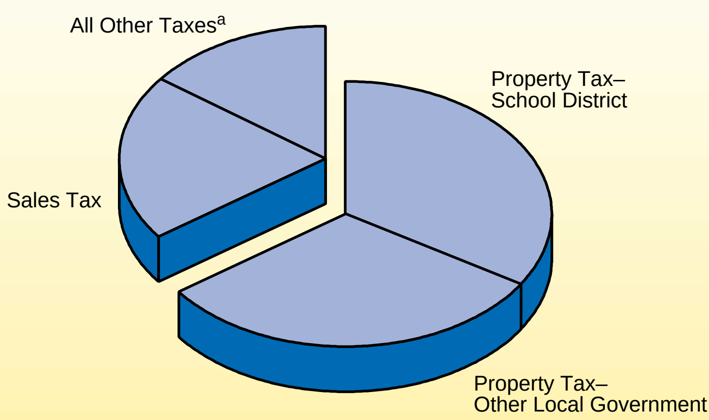
Included among other state taxes are the gross premiums insurance tax, alcoholic beverage taxes, cigarette and tobacco taxes, estate tax, lottery tax, various fuel-related levies, and disability and unemployment insurance taxes. The latter two taxes are directed into trust funds, and thus, do not constitute general state revenues.

Local Taxes

As discussed in greater detail later in this primer, local tax revenues come from the property tax, followed by the local portion of the SUT, business license taxes, utility user charges, and other miscellaneous revenues. Local governments, particularly counties, are also heavily reliant on state aid.

Local Tax Shares

1996-97



[a] Includes utility user charges, business license taxes, and franchise fees.

How Has the Tax Structure Changed Over Time?

The basic elements of California's current state tax system were put in place in the late 1920s and early 1930s. Prior to that time, state revenues were raised by an insurance tax, utility tax, and fuel tax. The severe fiscal disruptions that accompanied the depression, however, led to the adoption of both the PIT and state SUT. Since that time, California's tax system has remained largely intact, although a number of important statutory and constitutional modifications have occurred (see shaded box regarding how tax laws are adopted and changed). One of the most important of these changes was the adoption of Proposition 13 in 1978, which resulted in a dramatic reduction in property taxes and altered state-local

How Tax Laws Are Adopted and Modified

California's tax provisions are of two general types—statutory and constitutional.

Statutory Tax Provisions. These provisions typically reside in the California Revenue and Taxation Code and account for the vast majority of tax laws. They can be enacted either by the Legislature directly (as most are) or by a vote of the public (placed on the ballot either by the Legislature or through a voter-sponsored initiative). For measures that result in a net increase in tax revenues, a two-thirds vote of the Legislature is required; otherwise, a simple majority vote suffices. Typically, statutory tax provisions approved by the voters can be modified only through a subsequent vote of the people.

Constitutional Tax Provisions. Amending the California Constitution, including establishing or modifying constitutional state tax provisions, requires voter approval. As with statutory tax measures, constitutional tax measures may be put on the ballot either by the Legislature directly or by a voter-sponsored initiative. As with statutory provisions adopted by voters, changes to constitutional tax provisions require a subsequent vote of the people. Examples of constitutional tax provisions are Proposition 13 (involving local property taxation), personal income tax indexing, insurance taxation, and Proposition 99 (involving cigarette taxation).

Significant California Tax Law Changes Since Proposition 13

1982—Proposition 6 (eliminated gift and inheritance taxes; adopted "pickup" tax).

1982—Proposition 7 (indexed Personal Income Tax [PIT] tax brackets, standard deduction, and exemption credits for inflation).

1987—Federal conformity (repealed deduction of consumer interest expenses; limited business deductions; repealed partial capital gains exclusion; restricted use of tax shelters; repealed income averaging; eliminated PIT sales tax deduction; adopted net operating loss deductions, Subchapter S corporation option, and Alternative Minimum Tax [AMT]).

1988—Proposition 99 (imposed 25-cent per-pack surtax on cigarettes and other tobacco products) for health programs.

1991—Double-weighting of sales factor (amended corporate income tax apportionment formula).

1991—Temporary high-income tax rates (imposed PIT rates of 10 percent and 11 percent on high-income taxpayers, which lapsed in 1996).

1992—Proposition 163 (repealed the "snack tax" and prohibited future taxation of these products).

1992—Proposition 172 (imposed half-cent sales and use tax rate and dedicated revenues to local public safety programs).

1993—S corporation rate reduction (reduced from 2.5 percent to 1.5 percent).

1996—Corporation tax rate reduction (reduced franchise tax to 8.84 percent from 9.3 percent; lowered the AMT rate from 7 percent to 6.65 percent).

1996—Proposition 218 (limited fiscal authority of local governments and required majority of voters to approve increases in general taxes).

1998—Proposition 10 (imposed a 50-cent per-pack excise tax on cigarettes and other tobacco products) for health programs.

fiscal relations. Changes occurring since Proposition 13 are shown in the previous figure.

California's Tax Burden

The term "tax burden" describes a concept generally used in reference to how significant the taxes are that individuals and businesses pay. Tax burden measures can facilitate comparisons among states.

There are a variety of issues involving how the tax burden should be defined and measured (see shaded box). However, probably the single most commonly used measure of the tax burden is taxes paid as a percent of personal income. According to this measure, California's aggregate tax burden is about average when compared to other states.

- In 1995-96, the most recent year for which comprehensive interstate data are available, California's state and local taxes per $100 of personal income totaled $11.34.
- This was about equal to the national average ($11.30), very close to the average for other western states ($11.32), and somewhat below the average for other industrial states ($11.77).

How Does California's Tax System Rate?

There are a number of specific criteria that economists commonly cite as elements of well-designed tax systems.

- ***Broad Bases With Low Rates.*** Is the tax base sufficiently diverse so as to allow for the financing of public services to be shared broadly, with tax rates kept to a minimum?
- ***Economic Neutrality.*** Is the revenue system relatively neutral in terms of its influence on economic decision making by individuals and businesses?
- ***Equity.*** Are taxpayers in similar situations treated similarly, and are the differing tax burdens placed on taxpayers with differing characteristics fair?

Issues Regarding the Tax Burden

Terminology. One basic tax-burden issue involves using the term "burden" when referring to taxes generally. Taxes are used to provide public services that taxpayers value—such as education, parks, roads, and public safety. Without taxes, citizens either would have to pay directly for acquiring such services or forgo them altogether. Some economists argue that because such taxes simply measure the expenditures taxpayers incur to buy public services, a more neutral term—such as "tax price"—should be used as an alternative.

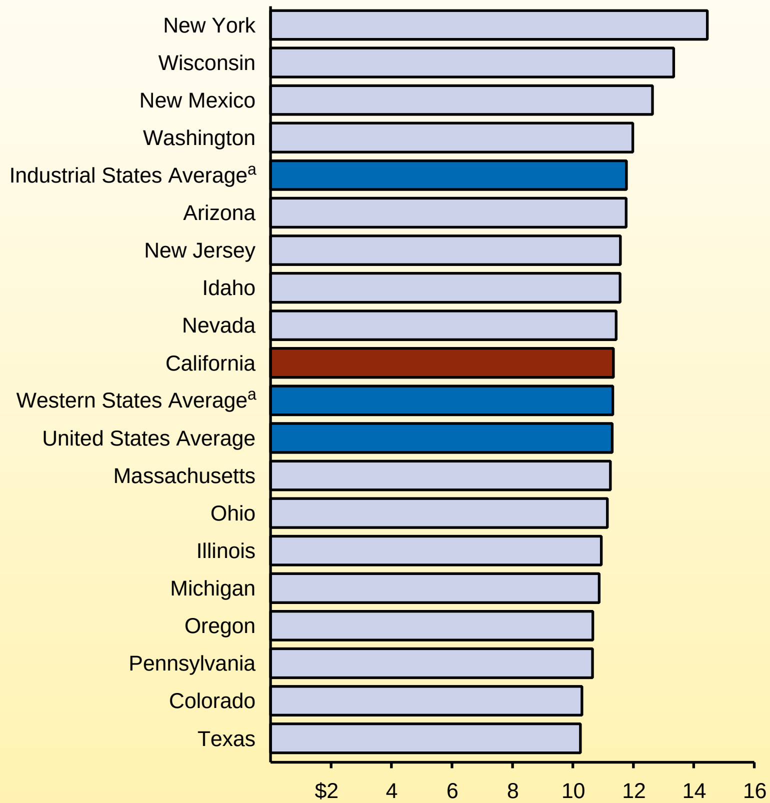
Measurement Issues. A second basic issue is how best to measure the tax burden. Among the most common approaches are taxes per capita, taxes as a percent of personal income, taxes as a percent of total statewide output, and taxes per worker. Another approach is to establish a set of representative taxpayer characteristics for individuals and businesses and compare what their taxes would be in different states. Each of these different measures has advantages and disadvantages in portraying a state's tax burden relative to other states.

Tax Incidence. A third issue is that tax burden calculations say nothing about exactly who ultimately pays the taxes, including: (1) how the tax burden is distributed by income level and (2) how it is eventually shared by consumers, workers, and business owners once the effects of taxes on prices and wages are considered.

Expenditure Impacts. A last issue involves how to interpret and use tax burden information. To the extent that a "high" or "low" tax burden simply measures amounts spent for public services, it says nothing about whether taxes are "too high" or "too low" in the minds of taxpayers. Thus, tax burden comparisons do not address the expenditure side, including how such expenditures benefit different income groups or regions.

California's Tax Burden Is About Average

1995-96 Taxes Per $100 of Personal Income



[a] In this primer western states include Arizona, Colorado, Idaho, New Mexico, Nevada, Oregon, Texas, Utah, and Washington. Industrial states include Illinois, Massachusetts, Michigan, New Jersey, New York, North Carolina, Ohio, Pennsylvania, and Wisconsin.

- ***Administrative Feasibility.*** Can the system be administered in an efficient, effective, and uniform manner, with minimal compliance and enforcement costs and a high degree of voluntary compliance?

- ***Adequacy, Stability, and Reliability.*** Can the system routinely be counted on to generate sufficient revenues to fund agreed-upon public services?

Although California's system scores relatively well in many areas, substantial challenges exist in other areas. As discussed in later sections, these challenges include capturing the "new economy's" increased reliance on intangible activities and E-commerce, addressing local revenue issues, and ensuring that tax expenditures are effective and efficient uses of taxpayers' money.

Personal Income Tax

Overview of the Personal Income Tax

The personal income tax (PIT) was established in 1935 and is the state's single largest revenue source. The PIT:

- Raised approximately $35 billion in 1999-00, accounting for roughly 40 percent of all revenues and half of General Fund revenues.
- Is levied on both residents and nonresidents, with the latter paying taxes on income derived only from California sources. There were over 13 million PIT returns filed in 1998, including 600,000 from nonresidents.
- Applies not only to individuals, but also to sole proprietorships, partnerships, estates, and trusts. In addition, the income "passed through" to individuals by Subchapter S corporations is subject to PIT taxation.
- Taxes all sources of income unless specifically excluded, including wages and salaries, interest, dividends, business-related income, and capital gains.

Filing Status and Tax Rates

Taxes are levied based on the filing status of the taxpayer. California has five filing statuses: single, married filing a separate return, married filing a joint return, surviving spouse, and head of household. There are six tax brackets for each filing status, with marginal tax rates ranging from 1 percent to 9.3 percent, depending on a taxpayer's income level.

Key PIT Features

The PIT's key features include:

- Single taxpayers account for 45 percent of total returns filed but only 26 percent of tax liabilities, whereas

California Tax Schedule for Married Couples Filing Joint Returns

2000 Tax Year

If Taxable Income is:		Computed Tax Is:		
Over	**But Not Over**	**Base Amount**	**Plus**	**Of Amount Over**
$0	$10,908	$0	1.0%	$0
10,908	25,852	110	2.0	10,908
25,852	40,802	408	4.0	25,852
40,802	56,642	1,006	6.0	40,802
56,642	71,584	1,956	8.0	56,642
71,584	—	3,152	9.3	71,584

married-filing-joint taxpayers constitute 40 percent of total tax returns but over 68 percent of tax liabilities.

- The PIT's tax brackets and certain credits and deductions are indexed annually to offset the impacts of inflation.
- There are approximately 85 PIT-related tax expenditure programs (TEPs), the sum of which totaled about $20 billion in 2000-01. These TEPs include a variety of income exemptions, income exclusions, tax deductions, and tax credits (the largest of which are shown in the next figure).
- A 7 percent Alternative Minimum Tax (AMT) is levied under certain circumstances. Its purpose is to restrict tax benefits from so-called tax preferences, including deductions and credits. In 1998, the AMT resulted in raising taxes for over 15,000 taxpayers by $128 million.

Largest PIT Tax Expenditure Programs

2000-01
(In Millions)

Program	Type of Provision	Revenue Reduction
Mortgage Interest Expenses	Deduction	$3,070
Employer Contributions to Pension Plans	Exclusion/Exemption	2,900
Employer Contributions to Accident and Health Plans	Exclusion/Exemption	2,200
Dependent Exemption	Credit	1,325
Social Security and Railroad Retirement Benefits	Exclusion/Exemption	1,100
Charitable Contributions	Deduction	1,000
Personal Exemption	Credit	940
Standard Deduction	Deduction	930
Proceeds from Life Insurance and Annuity Contracts	Exclusion/Exemption	850
Capital Gains on the Sale of a Principal Residence	Exclusion/Exemption	825

California's PIT Closely Follows the Federal PIT

The computation of California PIT liabilities is based on federal adjusted gross income (AGI). In turn, federal AGI equals total income from all sources less exempt or excluded income, plus certain federal adjustments. California generally conforms to federal PIT law except in specific circumstances. The procedure for calculating California's PIT is shown in the accompanying figure.

California's PIT Is Highly Progressive

California's PIT is a progressive tax, meaning that the "last" dollar of income earned is subject to increasingly higher marginal tax rates as income increases. As a result, the share of one's income paid in taxes generally rises with income. Put another way, the average tax rate rises with income, causing

How the California PIT Is Calculated

1998 Tax Year

Federal AGI ($764 Billion)

Plus/Minus

California Adjustments

Equals

California AGI

Minus

Deductions

Equals

California Taxable Income

Times

State Tax Rates

Equals

PIT Liability Before Credits

Minus

Tax Credits

Equals

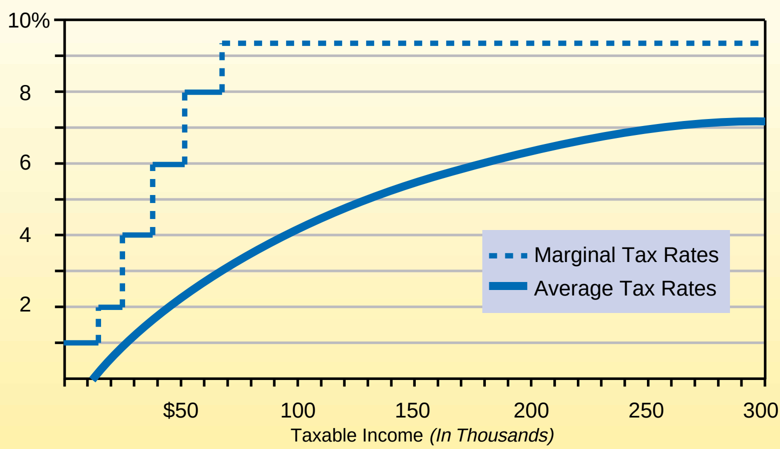
PIT Liability After Credits ($27 Billion) taxpayers with higher taxable incomes to pay a proportionately larger share of their income in taxes than those with lower incomes. For example, a married couple filing jointly with two dependents and taking the standard deduction would have an effective tax rate of 1.4 percent based on an income of $50,000, versus an effective rate of 4.8 percent based on a $100,000 income.

In 1998:

- Taxpayers earning annual incomes of $200,000 or more accounted for less than 3 percent of returns but almost 50 percent of liabilities.
- In contrast, taxpayers with AGI of less than $50,000 accounted for over 70 percent of returns but less than 10 percent of liabilities.

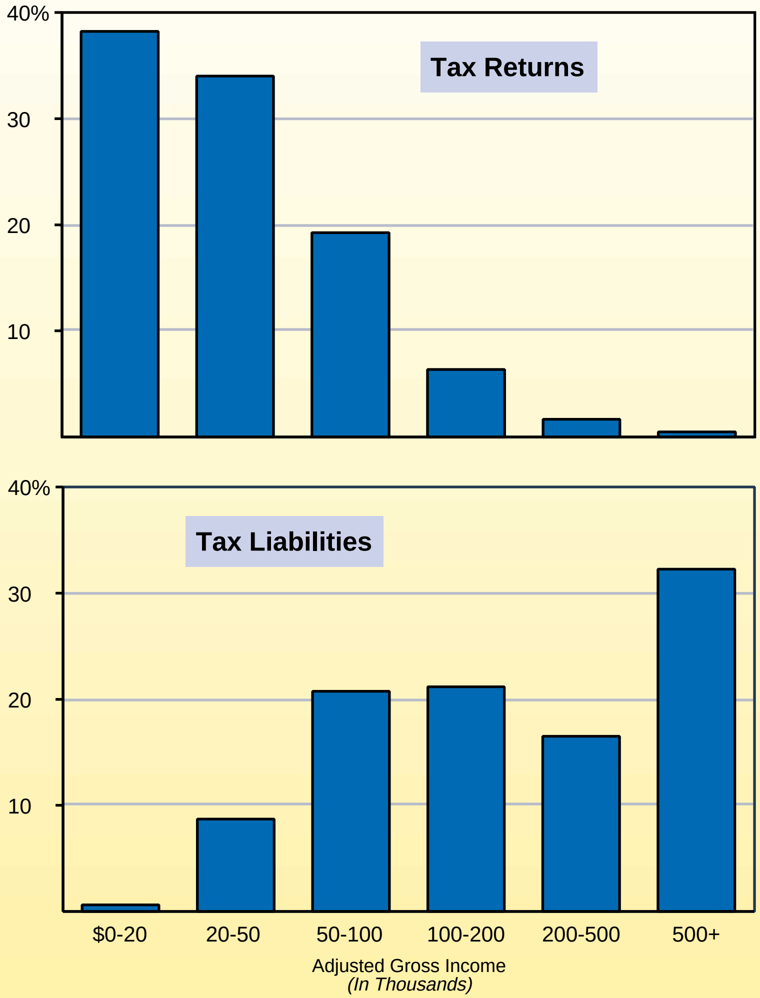
PIT Average and Marginal Tax Rates By Income Class

Joint-Return Taxpayers in 1998



Distribution of PIT Returns and Liabilities By Income Class

1998 Tax Year



Wages and Salaries Account for Most PIT Revenues

Of the different types of income subject to the PIT, wages and salaries constitute by far the largest portion. In 1998:

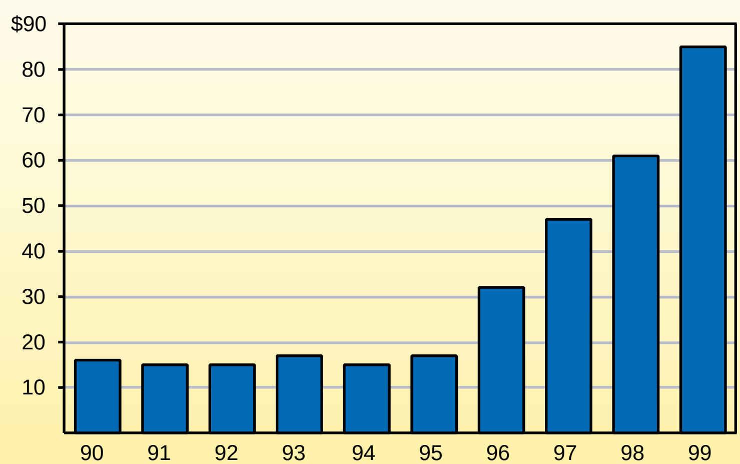
- Wages and salaries accounted for about 61 percent of PIT revenues (traditionally, about two-thirds of PIT liabilities have been associated with wages and salaries, with the lower 1998 share reflecting a historically large amount of capital gains).
- Capital gains accounted for 15 percent of PIT liabilities, having more than doubled its share over the past six years.

Capital Gains Have Been An Increasingly Important Source of PIT Revenues

Although wages and salaries continue to account for the majority of PIT revenues, the share attributable to capital gains has increased quite dramatically in recent years.

Capital Gains Have Exploded in Recent Years

(In Billions)



The growing importance of capital gains in generating PIT revenues reflects two main factors.

- First, the dollar amount of capital gains has shown rapid growth in recent years, averaging over 11 percent annually since 1993.
- Capital gains accrue disproportionately to high-income taxpayers and, thus, are taxed at higher-than-average marginal tax rates.

The increased role of capital gains also has brought with it certain revenue-related challenges. Most important, it has made the PIT inherently more volatile and difficult to forecast than previously. This is because capital gains themselves are highly variable, due to (1) their dependency on the volatile stock market and housing sectors and (2) the fact that most stock-related capital gains are not taxed in the year of accrual and can remain unrealized for many years.

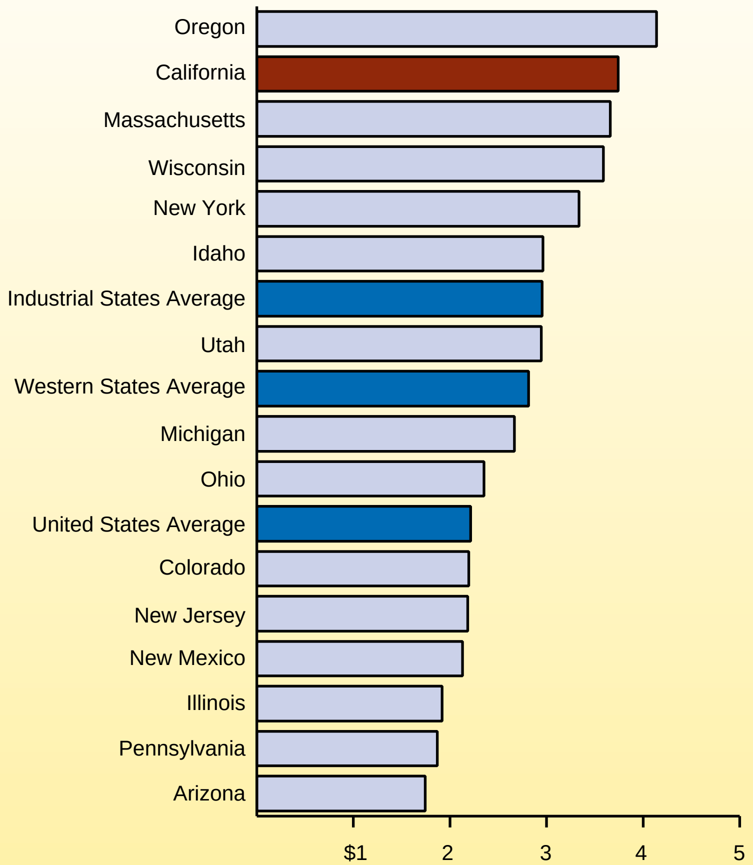
Comparisons To Other States

A PIT is imposed by 43 states and the District of Columbia. The PIT-related interstate comparisons of greatest interest involve its overall tax burden and its relative marginal tax rates. With regard to the former, the state's overall PIT tax burden—as measured by tax liabilities per $100 of personal income in 1998-99—is $3.74 (see following figure). This is above the average of both all other states ($2.21) and other western and industrial states ($2.81 and $2.95, respectively).

The latter issue of marginal tax rates is of special interest because high-marginal rates may in some situations result in discouraging work. California's highest-marginal rate of 9.3 percent is above that of most other states. Its lowest-marginal tax rate, however, is lower and covers a larger amount of income than in many other states. Of course, the fact that California's total burden for all taxes combined is

California's PIT Burden Is Above Average

1998-99 Taxes Per $100 of Personal Income



about average means that its higher PIT burden is offset by a lower combined burden for its other taxes.

Important PIT Policy Issues

Some key PIT-related policy issues facing policymakers include:

Comparison of PIT Marginal Tax Rates

Single Taxpayers, 1999

State	Starting Marginal Tax Rate	Applies to Taxable Income Up To	Top Marginal Tax Rate	Applies to Taxable Income Beginning
California	**1.00%**	**$5,264**	**9.30%**	**$34,548**
Oregon	5.00	2,350	9.00	5,850
New Mexico	1.70	5,500	8.20	65,000
Idaho	2.00	1,000	8.20	20,000
Ohio	0.74	5,000	7.50	200,000
New York	4.00	8,000	6.85	20,000
Wisconsin	4.77	7,620	6.77	15,240
New Jersey	1.40	20,000	6.37	75,000
Massachusetts	5.95	all	5.95	all
Arizona	2.87	10,000	5.04	150,000
Colorado	4.75	all	4.75	all
Michigan	4.40	all	4.40	all
Illinois	3.00	all	3.00	all
Pennsylvania	2.80	all	2.80	all

- ***Marginal Rate Structure.*** Should California's PIT marginal tax rates be reduced, and the cost be financed through base broadening?
- ***Federal Conformity.*** Should California more fully conform to federal PIT law in areas where it currently differs, such as capital gains tax rates, depreciation, certain credits, and net operating losses?
- ***Broad-Based Simplification.*** Should California move towards a more simplified PIT system with fewer special provisions for particular groups/businesses?
- ***Targeted Simplification.*** Alternatively, should California leave its basic system intact, but focus on simplifi-

cations in those PIT areas where the greatest complexities for taxpayers lie, such as the AMT?

- ***Tax Expenditure Programs.*** Are there certain PIT-related TEPs that are ineffective and inefficient, and therefore in need of elimination or modification?
- ***Reliance on the PIT.*** Has California become overly dependent on the PIT, given that it is a somewhat volatile revenue source and now accounts for over half of the state's General Fund total?

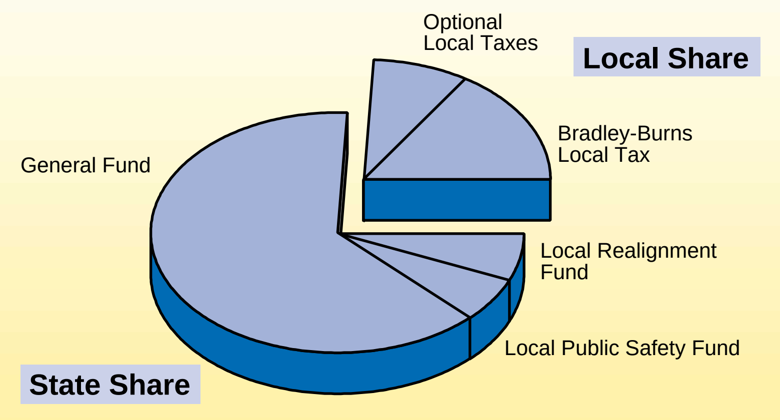
Sales and Use Tax

Overview of the Sales and Use Tax

The sales and use tax (SUT) is the second largest tax levied in California and is assessed at both the state and local levels. California is one of 45 states that levy a SUT with only Alaska, Delaware, Montana, New Hampshire, and Oregon not levying one. California's state-level SUT was established in the 1930s and its local SUT emerged in 1955. In 1999-00, California SUT revenues totaled about $32 billion, with about 75 percent going to the state and 25 percent to localities.

State-Local Split of SUT Revenues

1999-00



The Sales Tax Versus the Use Tax

California's SUT has two distinct components—the sales tax and the use tax.

- The *sales tax*, begun in 1933, is imposed on retailers selling tangible personal property in California. It is collected and paid by registered sellers and constitutes the bulk of revenues raised by the SUT.
- The *use tax*, begun in 1935, is imposed on the users of a product purchased out of state but brought into California for use (such as a mail order item from another state). Although required to be paid by purchasers, this remittance generally occurs only in certain circumstances (due to enforcement issues).

Taxed Items

The SUT is a tax on final sales of tangible personal property, such as clothing, household furnishings, appliances, and motor vehicles. Intermediate sales of goods (say, from a wholesaler to a retailer) are *not* taxed and, in addition, certain individual items are specifically exempted from the SUT. The largest of these tax expenditure programs (TEPs) involve utilities and home-consumed food. Services are largely exempt from taxation, although California does tax a few. Services are indirectly taxed, however, to the extent that their cost is incorporated into the final prices of tangible goods. For those states that directly levy a SUT on services, over half tax cleaning services, for example, while only six (Hawaii, Connecticut, Iowa, New Mexico, South Dakota, and Washington) tax professional and personal services.

SUT Rates Vary by County

The SUT rates in California differ by county, and range from 7 percent to 8.25 percent, depending on whether a county chooses to levy optional taxes.

Largest SUT Tax Expenditure Programs

1998-99
(In Millions)

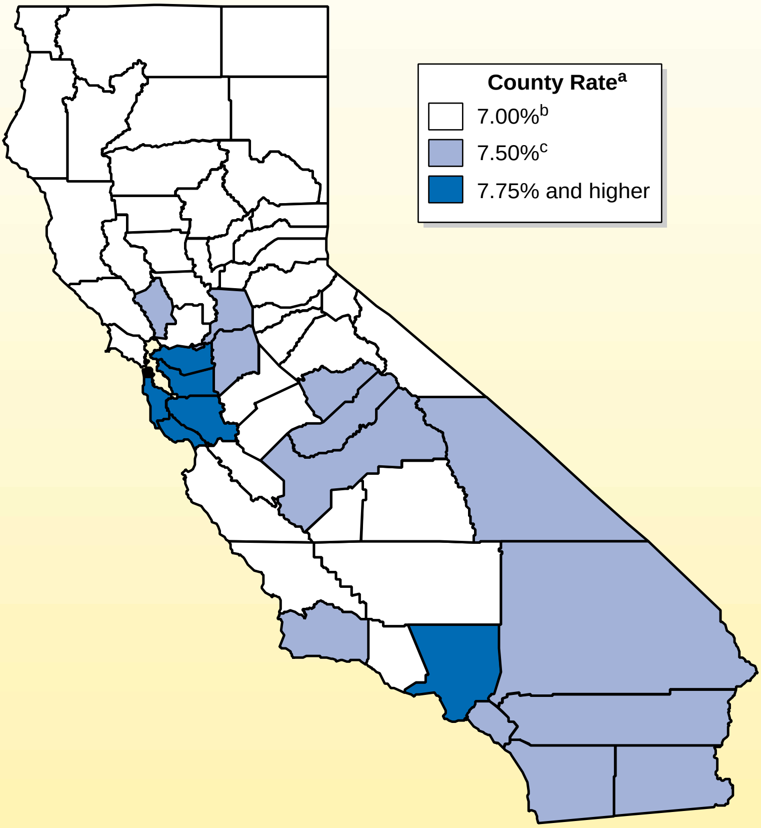
	Revenue Reduction		
Exclusion/Exemption	**State**	**Local**	**Total**
Gas, electricity, water, steam, and heat	$2,482	$782	$3,264
Food products	2,052	646	2,698
Prescription medicines	539	170	709
Custom computer programs	210	66	276
Candy, gum, and confectionery products	165	52	217
Animal feed	157	50	207
Bottled water	71	22	93
Free newspapers and periodicals	56	18	74

As of January 1, 2001, the average statewide SUT rate was 7.67 percent (weighted by sales). This includes:

- A *state* rate of 5.75 percent—4.75 percent for the General Fund and 1 percent for specified local purposes. From 2001-02 through 2005-06, the SUT on gasoline will be diverted to transportation-related special funds.
- A weighted average *local* rate of 1.92 percent, including 1.25 percent for general purposes and the remaining 0.67 percent from optional SUTs largely used for transportation (see shaded box). The maximum optional SUT rate is 1.50 percent.

Sales Tax Rates Vary by County

2001



[a] Reflects 0.25 percent reduction in state portion of rate for the 2001 calendar year.
[b] Includes Stanislaus, Nevada, and Solano (7.125%), and Sonoma (7.25%).
[c] Includes Fresno (7.625%).

Local SUT Levies

The sales and use tax (SUT) comprises on average about one-third of general purpose city tax revenues and 6 percent of county tax revenues and, thus, is a major local revenue source.

Uniform Local SUT. The 1.25 percent Bradley Burns Uniform Local Sales and Use Tax is allocated to cities and counties as follows (1) 0.25 percent to the county in which a sale occurs to fund transportation projects, and (2) 1 percent for general purposes to the city in which the sale occurs, or the county if the sale was in an unincorporated area. Special district taxes are allocated to the appropriate local district.

Optional Local SUT. Regarding the optional SUTs that localities can levy, these average 0.67 percent on a statewide basis, and are levied in 24 of California's 58 counties. They can be adopted by counties, cities, or special taxing jurisdictions or districts. The latter are formed to fund local programs such as transportation projects, hospital services, public libraries, and schools. California's 58 counties, 475 cities, and 35 special tax districts have a plethora of individual SUT levies that makes administering and allocating their revenues challenging.

These optional SUTs require two-thirds voter approval if the revenues are to be dedicated to a specific purpose. A majority vote is required for an additional general purpose local sales tax. Statewide, these optional taxes currently range from 0.125 percent to 1.25 percent.

Comparisons to Other States

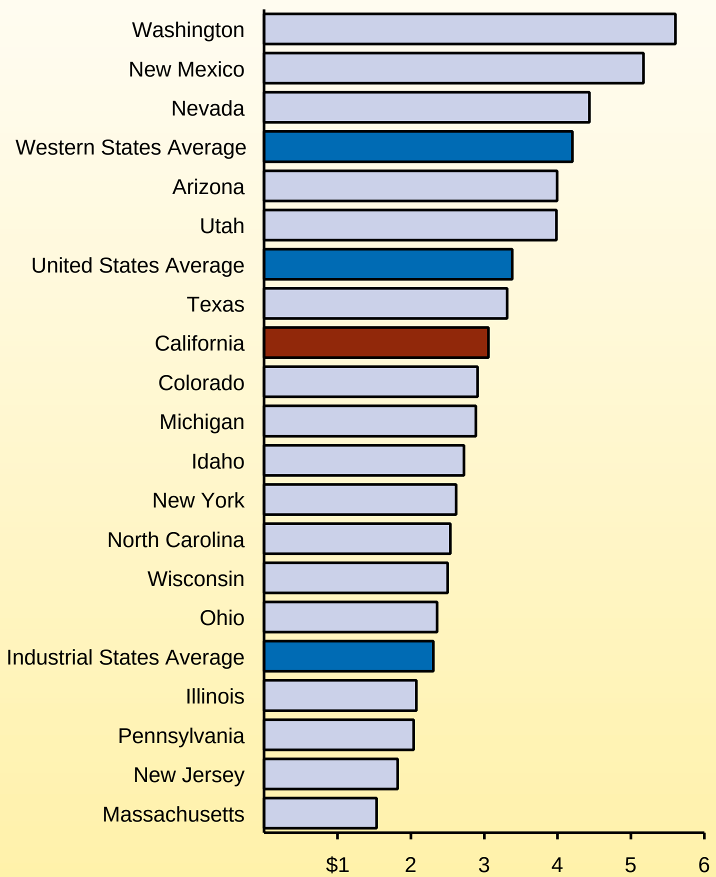
Compared to other western states and the large industrial states, California has a relatively high SUT *rate*—exceeded only by Washington and Illinois. However, because it also has many SUT exemptions and exclusions, its SUT revenues per $100 of personal income ($3.06 in 1995-96) are slightly below the national average and significantly below the western states' average.

Recent Trends and Future Performance

California's SUT revenues have increased at a healthy rate over the last few years; in 1998-99, for example, revenues increased by almost 9 percent. However, the tax performed poorly during the first half of the 1990s, and has represented a

California's SUT Burden About Average

1995-96 Taxes Per $100 of Personal Income



declining share of personal income over the last 20 years. This is due to changes in both consumption patterns and the structure of the economy, and raises questions as to its future performance.

SUT Tax Policy Issues

The basic structure of the SUT has been a topic of increased attention and concern for many years, especially in recent decades as the economy and California's fiscal landscape have experienced change. Key SUT-related issues include:

- ***Tax Expenditure Programs.*** Are certain SUT-related TEPs ineffective or inefficient, and therefore deserving of elimination or modification?
- ***Local Finances.*** How large a role should local SUTs be playing in local government finances and how do they fit in with overall long-term local government fiscal reform in California?
- ***Base Erosion.*** What is the long-term viability of the SUT, given the ongoing decline in the share of expenditures on taxable tangible goods and shift toward nontaxed services and intangible goods?
- ***Remote Sales.*** Tax advantages currently exist for purchases via the Internet and mail order catalogues, since states currently cannot require most out-of-state vendors to remit use taxes (see shaded box). How can and should this issue be dealt with?

Tax Policy and the Internet

The rapid development of Internet commerce has raised a number of important issues regarding state taxes and, in particular, the future of the state and local sales and use tax (SUT). The concerns relate both to the *fairness of the tax* as well as potential *revenue effects* on states and localities.

Tax Fairness. The issue of tax fairness exists because retail businesses with a physical presence in California must collect the SUT from purchasers, while businesses operating over the Internet (or other remote means) and with no physical presence in the state cannot be required to collect the tax. Some businesses argue that this is unfair because it creates a tax-generated bias toward remote sellers. Other businesses claim that it would be unfair for businesses with no physical presence in a state to be required to collect taxes.

Revenue Effects. Possible *revenue effects* on state and local governments is of concern due to two particular features of Internet commerce. First, if Internet commerce grows at the expense of growth in sales by traditional "main street" businesses, the SUT base will continue to decline, which could have a direct impact on state and local revenues. Second, Internet technology is capable of transforming numerous tangible goods into a nontangible form. These would then not be part of the SUT base, and would result in state and local revenue losses.

Internet commerce tax issues and suggested approaches for addressing these issues are discussed in the LAO publication, *California Tax Policy and the Internet*, January, 2000.

Bank and Corporation Tax

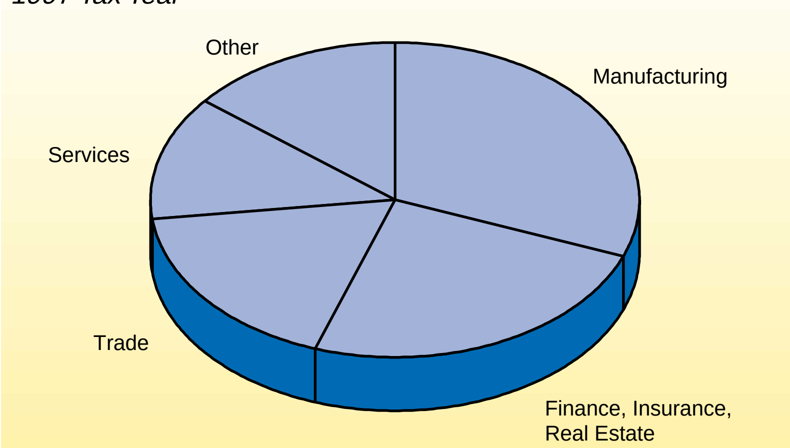
Overview of the Bank and Corporation Tax

California is one of 48 states to tax corporate profits, and its bank and corporation tax (BCT) is the state's third largest source of General Fund revenues. In 1999-00, it raised an estimated $6.1 billion, or 9 percent of the total. The BCT applies to all corporations which earn income derived from, or that is attributable to, sources in California. Nonprofit corporations (such as churches and charitable organizations) are exempt, as are insurance companies (which instead pay a gross premiums tax).

Of the nearly half million corporations filing BCT returns in California, only about 60 percent actually report profits and thus, pay BCT taxes. The remainder report losses, and thus,

BCT Revenue Shares by Industry Sector

1997 Tax Year



are subject only to the state's minimum tax. Those firms making profits are distributed among different industry sectors. Manufacturing firms account for almost one-third of all BCT tax liabilities.

The BCT actually encompasses three different individual taxes—the corporate franchise tax, corporate income tax, and bank tax. The corporate franchise tax is paid by most businesses in the state for the privilege of doing business in California, while the corporate income tax is paid by businesses which do not have sufficient presence or activity in the state for franchise tax purposes. The bank tax is paid by banks and financial institutions. All three components of the BCT are assessed based on income, with the franchise tax overwhelmingly dominating—accounting for over 98 percent of BCT revenues.

Key BCT Features

The BCT's key features include:

- A basic tax rate on profits of 8.84 percent and an $800 minimum tax except during a firm's first two years of operation. Banks and financial institutions pay at a higher rate of 10.84 percent to compensate for being exempt from certain local levies.
- Corporations are also subject to an Alternative Minimum Tax (AMT) similar in principle to the personal income tax (PIT) AMT, but at a slightly lower rate of 6.64 percent.
- A reduced tax rate of 1.5 percent for Subchapter S corporations, whose income "flows through" and is taxed on shareholders' PIT returns (see shaded box).
- The right to "carry forward" a certain percentage of the net operating losses (NOLs) incurred in one year so as to reduce taxable profits in subsequent years.

- The apportionment to California of a share of the domestic or worldwide business income for multistate and multinational corporations.
- A broad range of income exemptions, exclusions, and deductions, as well as tax credits. The value of these tax expenditure programs (TEPs) to taxpayers exceeds $3.7 billion (see the accompanying figure for a description of the largest TEPs).

Largest BCT Tax Expenditure Programs

2000-01
(In Millions)

Program	Type of Provision	Revenue Reduction
Subchapter S Corporations	Special Filing Status	$1,675
Increased Research and Development Expenses	Credit	460
Manufacturers' Investment Tax Credit	Credit	400
Water's-Edge Election	Exclusion/Exemption	350
Carryforward of Net Operating Losses	Deduction	320
Tax Exempt Status for Qualifying Corporations	Exclusion/Exemption	115
Exploration, Development, Research, and Experimental Costs	Deduction	110
Activities in Economically Depressed Areas	Credit	108

Relationship to Federal Law

California conforms in a great many BCT areas to federal corporate tax law regarding its basic structure and TEPs. However, some notable exceptions exist. For example, federal law offers more generous depreciation allowances, does not levy an entity-level tax on Subchapter S corporations, and allows 100 percent of NOLs to be "carried forward" as well as to be "carried back" to prior tax years.

Taxation of S Corporations

"S corporations" are business entities that receive the limited liability benefits of a corporation, but are taxed like a partnership. That is, their income is "passed through" to shareholders on a pro-rata basis and taxed at each individual's personal income tax rate rather than at the regular corporate rate. In 1998, there were more than 143,000 S corporation returns filed in California, generating $388 million in bank and corporation tax revenues. About one-in-three California corporations are S corporations. Regarding their tax treatment, S corporations:

- Pay a reduced corporate income tax rate of 1.5 percent (3.5 percent for financial S corporations).
- Are not subject to the alternative minimum tax, but are subject to the same minimum tax requirements as other corporations.

Most California S corporations are small businesses which also have elected federal Subchapter S corporation status, in that they have no more than 75 shareholders and only one class of stock. However, there also are many very large S corporations in terms of assets, sales, and net income.

Taxing National and International Corporations

The taxation of corporations doing business only in California is relatively straightforward in terms of computing their taxable profits, in that California profits equal the difference between receipts and allowable deductions (such as expenses for employee salaries). Most businesses filing under the BCT are California-only corporations; however, most corporate income—almost 75 percent—accrues to multistate and multinational corporations.

For these firms, California profits are determined by apportioning a share of their total domestic or worldwide

Example of BCT Income Apportionment Process

	Illustrative Calculation
Step 1: Add together total business net income from all relevant geographic areas.	$100 Million
Step 2: Calculate the firm's California shares of its total property, payroll, and sales.	Property Share = 50% Payroll Share = 40% Sales Share = 20%
Step 3: Calculate an average of these three ratios, using the sales factor twice.	$\frac{50 + 40 + 2(20)}{4} = 32.5\%$
Step 4: Multiply the resulting weighted ratio by total business income to get state taxable income.	32.5% x $100 million = $32.5 million
Step 5: Multiply state taxable income by the 8.84 percent BCT rate to get California BCT before credits.	8.84% x $32.5 million = $2.87 million

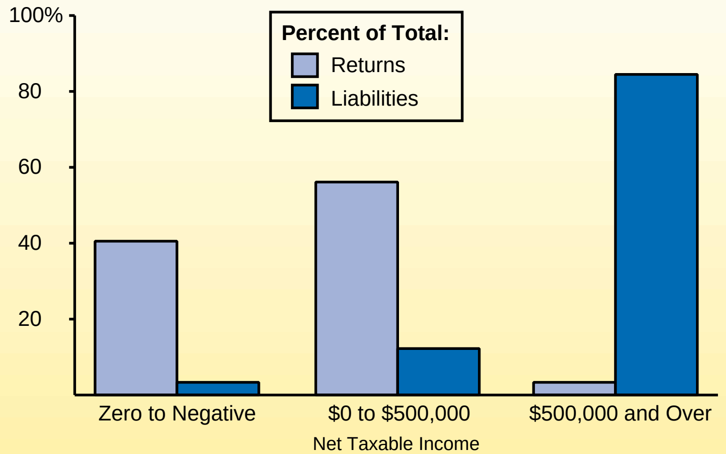
business income to California, based on California's weighted share of their total property, payroll, and sales (in most cases, the sales factor is double-weighted in doing this calculation). International corporations are given the option of using a domestic or worldwide base in doing their apportioning. In contrast to business income's treatment, nonbusiness corporate income, such as interest, is "sourced" to different states and nations using a set of prescribed rules.

The BCT's Distribution

In 1998, over 97 percent of BCT filers had taxable income of less than $500,000. The tax revenues generated by these firms accounted for about 15 percent of the total BCT taxes paid. Corporations earning a taxable income of $500,000 or more, in contrast, represented only 3 percent of returns, but had 85 percent of the tax liability.

BCT Returns and Liabilities by Net Income

1998 Tax Year



Comparisons to Other States

California's basic BCT rate of 8.84 percent is relatively high compared to other states (see accompanying figure). However, in making interstate tax-burden comparisons, one also must take account of more than just the tax rate—such as the various TEPs taxpayers benefit from. One way to adjust for this is by looking at corporate income taxes relative to personal income. In this regard, California's BCT burden is a bit above average for the U.S. as a whole (0.7 percent versus 0.5 percent).

Comparison of Key BCT Provisions

1999 Tax Year

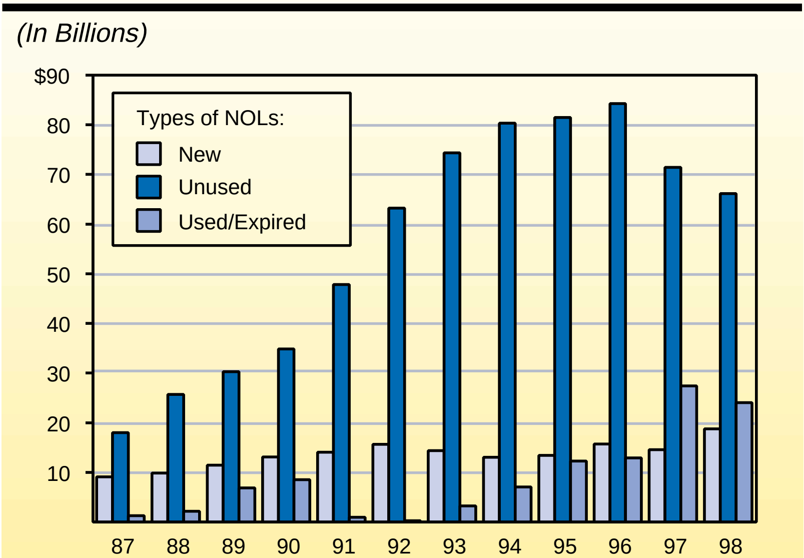
State	Tax Rate (%)	General Minimum Tax ($)	S Corporation Taxability
Pennsylvania	9.99%	—	Exempt
Massachusetts	9.50	$456	Exempt
New Jersey	9.00	250	Taxable
California	**8.84**	**800**	**Taxable**
New York	8.50	100 - 1,500	Taxable
Arizona	8.00	50	Exempt
Wisconsin	7.90	—	Exempt
North Carolina	7.50	—	Exempt
Oregon	6.60	10	Exempt
Ohio	5.10 - 8.50	50	Exempt
Utah	5.00	100	Exempt
Illinois	4.80	—	Taxable
Michigan	2.20	—	Taxable

The BCT's Future

The BCT's relatively subdued growth performance in California throughout much of the 1990s also occurred nationally and raises questions regarding the BCT's future role as a major revenue source. While BCT growth occurred in the most recent two years, its flatness in prior years during which the economy performed well remains a concern. For example, between 1994-95 and 1998-99 BCT revenues were basically stagnant even though overall economic growth was strong. This pattern is not fully understood, but some tax experts have pointed to increased use of creative corporate accounting and tax shelters—activities that could continue to constrain growth in the future.

Future BCT growth also could be affected by the substantial overhang of previously generated, but as yet unclaimed NOLs. Although the magnitude of NOLs has declined recently, they still total almost $70 billion, and are worth a potential tax savings of approximately $6 billion to California corporations (and thus, revenue losses to the state), if and when used.

Large "Overhang" Exists of Net Operating Losses (NOLs)



BCT Policy Issues

Key BCT issues involve:

- ***Income Apportionment.*** Does California's use of a double-weighted sales factor in its income apportionment formula best achieve the state's tax policy goals?
- ***Dividend Taxation.*** California (like the federal government) "double-taxes" dividend income, since it is taxed under both the PIT and BCT. Should this be changed?
- ***Integration.*** More generally, since both the PIT and BCT tax income, some have proposed integrating the two taxes in some fashion. Should this be considered?
- ***Federal Conformity.*** California conforms to federal BCT law in many areas. Is California's policy of generally conforming still appropriate, and should additional conformity occur where it does not currently exist (such as with depreciation)?
- ***Tax Expenditure Programs.*** Are certain BCT-related TEPs ineffective or inefficient and, therefore, deserving of elimination or modification?
- ***Revenue Performance.*** Given the BCT's relatively subdued growth performance in the recent past, what will its growth be and are there associated problems with how the tax is being administered and enforced?

Other State Taxes

California imposes an insurance tax; estate tax; alcoholic beverage tax; and various tobacco-related, gambling-related, and motor vehicle-related levies. In addition, employees and employers pay taxes into trust funds to finance the state's disability and unemployment insurance programs.

The Insurance Tax

Implemented in 1911, the insurance tax is one of the oldest taxes in California. The tax is levied on the premiums sold by insurance companies, and is in place of all other state taxes on insurance companies except real estate taxes and license fees. The fourth largest General Fund revenue source, it raised an estimated $1.3 billion (2 percent of the total) in 1999-00 from the approximately 2,000 companies subject to it.

- The tax base is net premiums written in the previous calendar year and dividends.
- Since 1990, the tax rate has been 2.35 percent.
- There is no corresponding insurance gross premiums tax at the federal level. Rather, insurance companies pay the standard federal corporate income tax.
- Special provisions apply to (1) title insurers and ocean marine insurers, which must use a different base, and (2) certain pension and profit-sharing insurance contracts and specialized insurers, which are taxed at different rates.

The Estate Tax and the Generation-Skipping Transfer Tax

The fifth largest source of General Fund taxes, the Estate Tax and the Generation-Skipping Transfer (GST) Tax accounted for an estimated $937 million in 1999-00, or a bit under 2 percent of the total.

Estate Tax

This tax was established by Proposition 6 in June 1982, which eliminated the state's Inheritance and Gift Tax law. The tax is levied on the adjusted value of property holdings of individual taxpayers upon their deaths. However, the tax imposes no net burden on California taxpayers. This is because federal law allows for a credit against the federal estate tax for any state estate taxes paid, and the state's rate is set equal to the maximum allowable federal credit. Since the state is able to "pick up" revenues for itself at no cost to taxpayers through this mechanism, the state's tax is often referred to as the estate pick up tax.

Example of How California's Estate "Pick-Up" Tax Works

	Total Taxes on an $800,000 Estate	
	Without State Tax	With State Tax
Gross federal tax	$65,750	$65,750
Minus maximum allowable credit for state tax	—	25,680
Equals net federal tax	$65,750	$40,070
State pick-up tax	—	25,680
Total federal and state taxes paid by estate	**$65,750**	**$65,750**

Generation-Skipping Transfer Tax

Similar to the estate tax, California's GST tax is equal to the amount allowable as a credit under federal law. The GST tax is imposed only on the value of interests in property that actually pass to certain transferees.

Motor Vehicle-Related Levies

Motor vehicle-related levies are the main source of state special fund revenues, accounting for an estimated $8.4 billion—or over half of the special fund total.

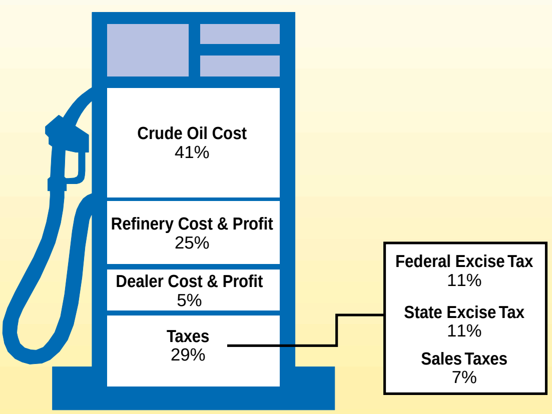
Fuel Taxes

Accounting for the largest share of motor vehicle-related levies, state fuel taxes are of three types.

- The *Motor Vehicle Fuel License Tax*, or so-called gas tax, is imposed on fuel distributors per gallon of fuel distributed. This levy accounts for by far the greatest share of fuel-related tax revenue.
- The *Use Fuel Tax* is an excise tax on each gallon of fuel used. This is mainly levied on "alternative" fuels such as compressed natural gas (CNG), liquified petroleum gas (LPG), and ethanol.
- The *Diesel Fuel Tax* is levied on the sale and delivery of diesel fuel and is generally collected from distributors.

Estimated Gas Price Components

Based on 2000 Average Price of $1.61 per Gallon



The tax rates are $0.18 per gallon for each of the above three taxes, which is in addition to federal excise taxes imposed. Together, these state taxes accounted for approximately 20 percent ($3.1 billion) of special fund revenues in 1999-00. The sales and use tax (SUT) is also charged on the sale of fuel and, except in the case of diesel fuel, is levied inclusive of excise taxes.

There are a number of important tax policy issues regarding fuel taxes including how they should be levied and what their allocation should be. For example:

- ***Application of the Tax.*** There have been proposals to change the gas tax from a per-gallon excise tax to an ad valorem excise tax based on wholesale price. Proponents argue that this would result in revenues more closely tracking increasing demand for transportation infrastructure.
- ***Sales and Use Taxation.*** Is it appropriate to continue the current practice of levying the SUT "inclusive" of the fuel excise tax?
- ***Social Costs.*** While gas taxes are loosely linked to the use of the state transportation system, some argue that gas is undertaxed in that no taxes are directly levied on fuel for indirect costs imposed on society by automobiles—such as congestion and pollution. Should this be addressed?

Vehicle License Fee (VLF)

The VLF is an annual fee on the depreciated purchase price of a registered vehicle in California, levied in lieu of taxing vehicles as personal property. The revenues, which totaled an estimated $3.4 billion in 1999-00, are distributed to cities and counties.

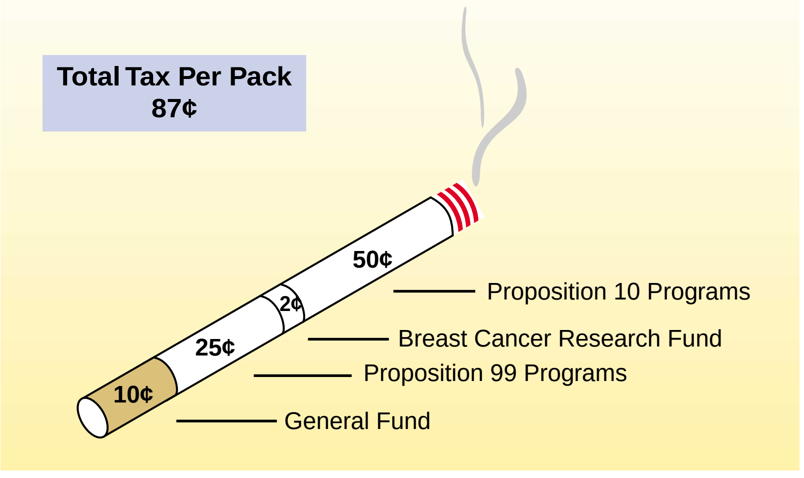
- The VLF has been significantly reduced in recent years, with the cumulative reduction reaching 67.5 percent in 2001.
- Cities and counties, however, receive the same amount of revenues as under prior law, since the reduced VLF revenues are replaced by direct General Fund spending.

Tobacco-Related Taxes

These taxes raised an estimated $1.3 billion in total state revenues in 1999-00, with the proceeds used for both General Fund and special fund-related purposes. The state's cigarette tax is currently $ 0.87 per pack (20 cigarettes) and is levied on cigarette distributors. As shown, the total tax is comprised of both General Fund and special funds components.

As with other taxes, generally, consumers ultimately share in the burden of the tax in the form of higher retail prices. Other tobacco products (such as cigars, chewing tobacco, pipe tobacco, and snuff) are taxed at a rate that is equivalent to the tax on cigarettes. In addition to state excise taxes, a tax of

California's Cigarette Excise Tax



$0.34 per pack is imposed by the federal government, which will increase to $0.39 per pack on January 1, 2002.

The key policy issue regarding these taxes is whether the programs they support will experience funding pressures, due to declining tobacco consumption associated with health concerns, smoking restrictions, litigation settlement costs, and the increased prices brought on by high excise taxes.

Alcoholic Beverage Taxes

Excise taxes are imposed on the sale of alcoholic beverages by manufacturers on a per-gallon basis. California's alcoholic beverage tax is levied in addition to a federal excise tax. In addition, annual license fees must be paid by retail establishments selling liquor. As shown in the accompanying figure, different tax rates apply, depending on the beverage.

General Fund revenues raised from this tax in 1999-00 totaled an estimated $274 million. Revenues generally de-

Alcoholic Beverage Tax Rates

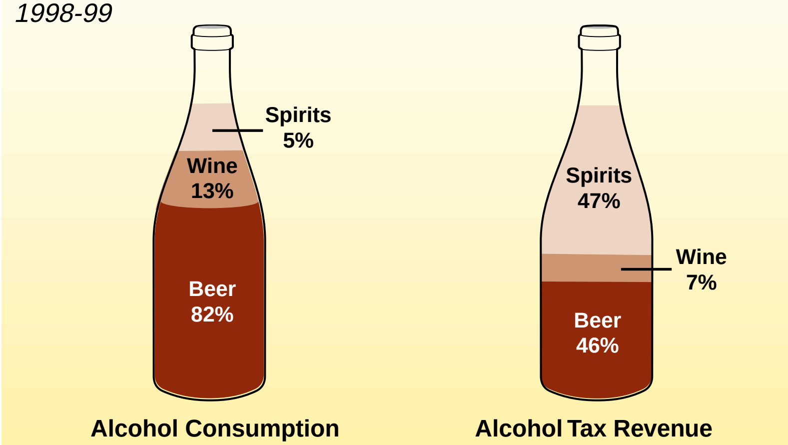
Beverage	Tax Per Gallon
Beer, wine, and sparkling hard cider	$0.20
Champagne and sparkling wine	0.30
Distilled spirits[a]	3.30

[a] For 100 proof or less. Tax is doubled for higher proof.

clined between 1991-92 and 1996-97, but have remained relatively stable since that time. The majority of revenues come from distilled spirits and beer.

Shares of Alcoholic Beverage Consumption and Revenues

1998-99



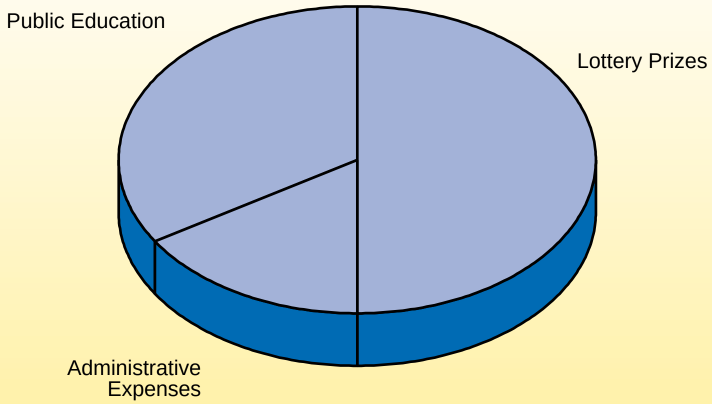
Gambling-Related Taxes

The California State Constitution allows for a state-run lottery and wagering on horse races, as well as bingo for charitable purposes.

The California State Lottery

The lottery was established by Proposition 37 (November 1984). The California State Lottery Act sets forth how the proceeds of lottery ticket sales shall be distributed—half returned to bettors, up to 16 percent for administrative expenses, and at least 34 percent to education. Lottery wagering was estimated to total $2.6 billion in 1999-00, of which $774 million went to K-12 education, with additional amounts to other public education components. Lottery revenues are a minor source of funds for schools. For instance, they represented approximately 1.7 percent of total K-12 school revenue in 1999-00.

Allocation of Lottery Proceeds



Horse Racing Levies

Horse racing license fees and taxes are levied on the amounts wagered at horse racing meets. The tax rate ranges from 0.4 percent to 2 percent depending on the style of racing, the type of wager, and where the wager is placed. In 1999-00, state revenues from these levies amounted to an estimated $35 million, reflecting an approximately 50 percent decline from previous years largely due to wagering-related tax relief enacted in 1998-99.

Employment-Related Taxes

State Disability Insurance (SDI) Taxes

The SDI tax is levied on employees in the form of payroll deductions in order to fund the disability insurance program. This program provides short-term insurance benefits to offset, in part, lost wages due to nonjob-related illnesses, injuries, and pregnancy. For 2000, the SDI effective contribution rate is 0.65 percent of the first $46,327 of an employee's annual income.

- California is one of six states to operate a publicly funded disability insurance program.
- Almost 11 million employees contribute to the SDI program. Coverage is mandatory for most Californians, with some limited exceptions.

Unemployment Insurance (UI) Taxes

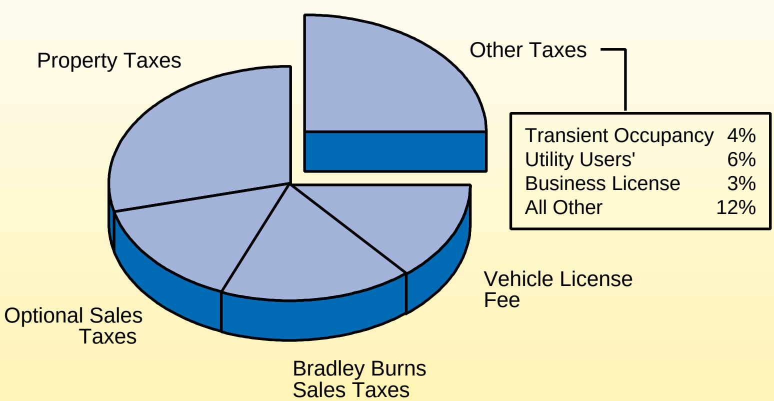
The UI tax is levied on employers. Tax revenues provide partial wage replacement to unemployed workers looking for new work. Employers pay taxes on up to $7,000 in annual wages paid to each worker. The actual tax rate depends on the employer and the amount of benefits paid to former employees. The UI program was created by the federal Social Security Act of 1935 and it is administered by states. All states have similar federal-state programs, but rates and provisions vary.

Local Taxes

Local taxes account for about 35 percent of total (city and county) local government revenues in California, and amounted to in excess of $20 billion in 1997-98. The main sources of local tax revenues include the property tax (29 percent), the local component of the sales and use tax (SUT) (32 percent), the vehicle license fee (VLF) (14 percent), and a variety of "all other" levies (25 percent). The latter include the utility users' tax, business license tax, transient occupancy tax, and various other levies. The local SUT was discussed in Chapter 3. The VLF was discussed in Chapter 5 as a motor vehicle-related tax. This section focuses on the property tax and all other local taxes.

Local Tax Sources[a]

1997-98



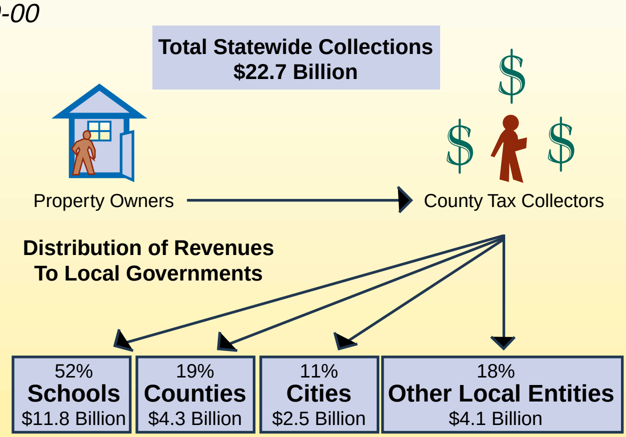
[a] Cities and counties.

Property Tax

The property tax is a major source of tax revenue for California's local governments, including cities, counties, school districts, and special districts. Property taxes have been part of California's tax structure since 1849, and are among the most stable of its revenue sources. In 1999-00, the property tax raised an estimated $22.7 billion. The current distribution procedures and statewide average allocation percentage are shown in the accompanying figure.

Property Taxes Are Distributed to Many Entities Within Counties

1999-00



Property Tax Base. The property tax applies to all classes of property—residential, commercial, industrial, agricultural, open space, timberland, vacant land, and certain personal property. Real property includes land, buildings, fixtures, mineral rights, and other components. Personal property is generally limited to businesses and includes things like equipment, machinery, and aircraft.

Certain types of property are exempt, such as property owned by governments or charities, household personal property, automobiles, securities, and business inventories.

Property Assessment. The property tax is based on the assessed value of real and personal property in the state. Most property is assessed locally by county assessors, although certain types of property—including railroads, utilities, and other similar property—is assessed by the state. Prior to the adoption of Proposition 13 in 1978, all property was assessed at the market rate and a locally determined tax rate was applied to the assessed value in order to calculate the total tax levy.

The adoption of Proposition 13 resulted in a number of restrictions on the property tax which limit the ability of local governments to raise revenues from this tax.

Locally assessed real property is assessed based on the acquisition value (while other property continues to be assessed at market value).

- Assessed value is allowed to increase annually by the lesser of 2 percent or the rate of inflation.
- Upon resale, real property is reassessed at market value, based on the purchase price.

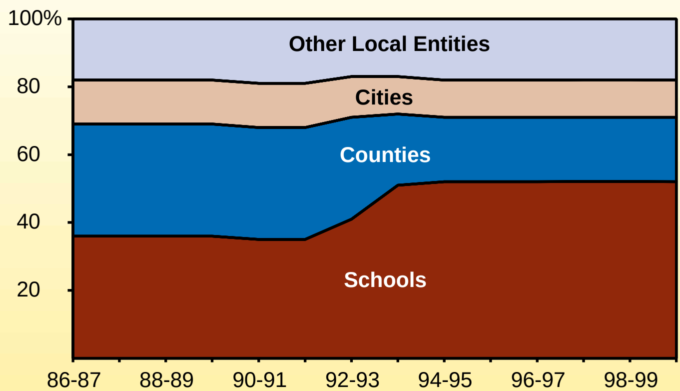
For most other property (locally assessed personal property or state assessed real property), the assessment practice continues to be based on market value. Measures of market value include purchase price, adjusted sales price of comparable properties, replacement cost, and discounted cash-flow valuation.

Property Tax Rate. The countywide property tax rate is limited to 1 percent of assessed value. Additional levies are permitted for voter-approved general obligation debt. For 1998-99, the average countywide tax rate was 1.069 percent, with the highest at 1.167 percent for the City and County of San Francisco.

Property Tax Allocation. As a percent of total revenues, the share contributed by the property tax varies widely among different governmental entities. Proposition 13 gave the state responsibility for allocating the property tax among local governments. In 1992 and 1993, the state shifted property tax allocations from cities, counties, and special districts to schools to reduce state costs. This was accomplished through a mechanism known as the Educational Revenue Augmentation Fund (ERAF).

ERAF Shifted Property Taxes From Local Government to Schools

Share of Property Tax Collections



Property Tax Policy Issues

The property tax has numerous issues associated with it.

- ***Basic Fairness of the Tax.*** Under current assessment methods, owners of identical properties can pay vastly different taxes solely based on when the property was purchased.

- ***Property Tax Allocations.*** The most appropriate way of allocating the property tax among local governments continues to be a topic of discussion and debate.
- ***Personal Property Assessment.*** Issues have been raised regarding the appropriate methodologies used for assessing the value of personal property, which largely affects businesses.

Other Local Taxes

Utility Users' Tax

The utility users' tax (UUT) accounts for approximately 13 percent of city general purpose tax revenues. It is assessed on the consumer of one or more of the following services: electricity, gas, cable television, water, and telephone. Some counties also levy the UUT. Tax rates are set by the governing body and range from 0.5 percent to 12 percent. Local government UUT revenues totaled more than $1.3 billion in 1997-98.

Business License Tax

The business license tax (BLT) is a type of excise tax imposed on businesses for the privilege of operating within a city or county. The tax is most commonly based on gross receipts or levied at a flat rate. Cities rely on the business license tax for roughly 7 percent of general purpose tax revenues. The BLT revenues contributed more than $700 million to local governments in 1997-98.

Transient Occupancy Tax

The transient occupancy tax (TOT) is imposed on occupants for the privilege of occupying a motel, hotel, or similar room. The tax represents an attempt on the part of many local governments to "export" a portion of the tax burden to nonresidents and/or to recoup the costs imposed by nonresidents.

Cities and counties collected nearly $900 million in TOT revenues in 1997-98.

Other Taxes

Local governments impose a variety of other general taxes, including: documentary transfer taxes, admissions taxes, and parking taxes. In addition, special taxes such as the Mello-Roos Community Facilities Tax, library services tax, parcel tax, and police and fire services tax are also imposed by some local governments. These vary widely across different types of local governments.

Glossary of Common Tax Terms

Ad Valorem Tax—A tax assessed based on the dollar value of an item or activity. Typical examples are property and sales taxes. Ad valorem taxes contrast with per-unit taxes, such as California's alcoholic beverage and cigarette taxes, which are assessed at a fixed dollar amount per unit of the item purchased.

Adjusted Gross Income—An amount calculated for income tax purposes which equals total income minus various exclusions, exemptions, and adjustments.

Alternative Minimum Tax (AMT)—An additional tax that must be computed by individual and corporate taxpayers who take advantage of certain special tax preferences. If this tax exceeds the regular tax liability, the excess amount is separately assessed. In addition, the AMT can reduce the amount of tax credits that can be claimed, even if a separate add-on AMT liability is not owed. The underlying intent of the AMT is to ensure that some tax is paid by those who claim special tax preferences. The state's AMT is (in many respects) similar to the federal AMT.

Bracket Creep—Since monetary wages and other types of compensation often go up with inflation, inflation can "push" taxpayers into higher tax brackets, even though their "real" income may be unchanged. This can inadvertently lead to a higher personal income tax (PIT) marginal tax rate being applied and increased tax liabilities being assessed.

Capital Gains—Income or profit from the sale of capital assets, such as real or personal property, stocks and bonds, and other property held by taxpayers. Certain capital losses can occur as well as capital gains.

Carryback or Carryforward—The amount of business-related losses from one year that can be used to offset taxable income in past years (a carryback) or in future years (a carryforward). Such losses are due either to the sale of capital assets or to the realization of a net operating loss (see below).

Credit—An amount which can be subtracted from the computed tax owed, and thereby reduce a tax liability. A credit is usually tailored to benefit specific categories of individuals or businesses, or encourage certain types of behavior. Examples are California's tax credits for business investment, research and development expenditures, and senior citizens.

Deduction—Amount subtracted from gross income to arrive at taxable income. Examples for individuals include home mortgage interest expenses and charitable contributions. Examples for businesses include employee salaries and depreciation charges for equipment.

Depreciation—Income tax deduction allowed for the decrease in the value of structures and capital assets due to use and obsolescence. Depending on the type of asset and the year placed in service, different methods for calculating depreciation are applicable.

Effective Tax Rate—Percentage of market value, income, or other taxed amount that a tax liability represents. Also known as the average tax rate.

Excise Tax—General term for a per-unit levy on the manufacture, sale, or use of a specific service or commodity. Examples include California's excise taxes on alcoholic beverages and cigarettes.

Exemption—Refers to the partial or complete exclusion from taxation of specified items, such as certain types of income under the PIT or transactions under the sales and use tax (SUT). Can constitute either a specified dollar or percentage amount, and can apply to specified types of individuals, businesses, property, institutions, sources of income, or other classifications. An example is the exemption of income from taxation of nonprofit organizations, as long as receipts received are related to the nonprofit activities of the entity.

Incidence—Refers to who bears the burden of a tax. Tax incidence can take two forms—economic and statutory incidence. Economic incidence involves who ultimately bears the cost of the tax. This may differ from statutory incidence, which is simply who initially pays the tax. For example, a landlord initially pays the property tax and thus has statutory incidence, whereas renters share in economic incidence to the extent that the property tax is "passed on" to them in the form of higher rent.

Income Apportionment—The process of determining the amount or share of a taxpayer's income that is allocable to a particular geographic jurisdiction—such as California—for tax purposes.

Indexing—The annual upward adjustment under the income tax of marginal tax bracket boundaries, certain credits, and the standard deduction by the Consumer Price Index to compensate for inflation.

Marginal Tax Rate—The income tax rate that is applied to the highest or last dollar of a taxpayer's income.

Marriage Penalty—The amount by which the tax liability of a married couple exceeds their combined tax liability that would have existed had they not been married and filed as two single taxpayers.

Net Operating Loss—When the gross income of a business is exceeded by its allowable deductions, thereby causing a loss for tax purposes. In California, these losses may be carried forward and used to offset positive net income in future years, subject to various rules.

Nexus—Minimum threshold of "connection" or "presence" with a taxing jurisdiction that is required before taxes or tax collection responsibilities can be imposed on out-of-state individuals and businesses.

Passive Income—Income from trade or business activities for which a taxpayer does not actively participate, such as activities involving certain limited partnerships or rental properties. Net losses (called "passive losses") from these types of investments are limited in their use as offsets to regular "active" income, such as wages and salaries. Unused passive losses may be carried forward to offset passive income in the future, however.

Progressive Tax—Occurs when high-income taxpayers pay a greater percentage of their income in tax than do low-income taxpayers. A regressive tax involves the opposite situation.

Subchapter S Corporation—A "closely held" corporation with a relatively limited number of shareholders (75 or less), that qualifies for and elects special tax treatment, including the "pass through" of income to its shareholders for tax purposes.

Tax Base—The individuals, entities, objects, transactions, or other types of activities to which a tax is applied.

Tax Bracket—An upper- and lower-bounded range of taxable income levels within which a particular marginal tax rate is applied. California's PIT structure has six different income tax brackets for each of its five different filing statuses. As one moves to higher and higher brackets, a progressively higher marginal tax rate is applied.

Tax Expenditure Program—A tax provision—such as an exemption, exclusion, credit, deduction, deferral, or preferential tax rate—which deviates from the "basic tax structure" and results in a reduction in government revenues that would otherwise be raised.

Throwback—In applying the income apportionment formula to multistate and multinational corporations, the sales of tangible personal property are usually attributed to the "destination state" to which the goods are shipped. However, when the destination state does not have jurisdiction to tax the corporation involved, the sales are "thrown back" to the geographic point of their shipment when making the apportionment calculation.

Value Added Tax (VAT)—A VAT is similar to a sales tax. However, rather than levied on a good's final sales value, it is assessed at each stage of the manufacturing process, based on the increase in the product's value attributable to that stage. Many countries throughout the world levy VATs, including many in Europe.

Water's-Edge Combination—One of two main methods for multistate and multinational corporations to use in combining the income of their various geographic activities in order to determine the amount of California taxable income. The water's-edge method combines activities from the 50 states of the U.S. and certain tax havens. The alternative method—worldwide combination—uses total income from all geographic jurisdictions throughout the world.

Worldwide Combination—The second of two main methods for multistate and multinational corporations to follow in combining their geographic income in order to determine the amount of California taxable income. In California, this method must be used if water's-edge election is not made.

UDITPA—Acronym for Uniform Division of Income for Tax Purposes Act. First drafted by the National Conference of Commissioners on Uniform Tax Laws in 1957, it provides a uniform method for allocating the income of multistate and multinational taxpayers among states for income tax purposes. Use of this method both keeps income from escaping taxation altogether and from being taxed more than once.

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