- ✦ **Personal Income Tax**
- ✦ **Bank and Corporation Tax**

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✦ INCOME TAXES—OVERVIEW

This section provides information on tax expenditure programs (TEPs) associated with the income tax liabilities of individuals and businesses. These programs affect the amount of General Fund revenues raised by the state's first and third largest taxes—the Personal Income Tax (PIT) and the Bank and Corporation Tax (BCT), respectively. Both of these taxes are administered by the California Franchise Tax Board (FTB). The following provides a brief summary of the PIT and BCT.

PERSONAL INCOME TAX

The PIT is paid by all California residents and nonresidents who receive income from sources in the state. Estates and trusts are also required to pay personal income taxes. The largest sources of taxable income under PIT include wages and salaries, interest, dividends, rents and royalties, net capital gains, and net business income. Business income includes the distribution of profits from partnerships, sole proprietorships, and Subchapter S corporations to shareholders or partners. Subchapter S corporations are also subject to an entity-level corporate tax on their net taxable income.

California's PIT law conforms to federal PIT law in many areas, which helps simplify both the calculations of tax liabilities for taxpayers, as well as the administration and enforcement activities of the FTB. Filing under California's PIT system, for example, builds upon preliminary steps carried out for the calculation of federal PIT liabilities.

Basic Calculation of State Income Tax Liabilities. Figure 1 provides a flowchart of how California's PIT liabilities are calculated. For the purposes of calculating PIT, there are four basic steps involved:

- **Step 1—Federal Adjusted Gross Income.** Calculation of a taxpayer's state PIT liability first requires the calculation of the taxpayer's federal *adjusted gross income* (AGI). To do this, income from all sources is first measured and then modified by subtracting income that is exempt (or excludable) from *federal* taxation. Some of the more notable examples of exempt income include certain social security benefits, scholarships and fellowships, and gifts under a certain dollar amount. Once completed, this calculation provides a measure of *gross* income (defined as income from all sources except that which is exempt or excluded) which is the starting point for the taxpayer's federal income tax calculation. Following this, certain *adjustments* are made to gross income, such as subtracting alimony paid or payments to IRAs or Keogh plans, to finally arrive at the measure of *federal* AGI.
- **Step 2—California Taxable Income.** Federal AGI marks the starting point for the state income tax calculation. The next step is to make specified *adjustments* to federal AGI, subtracting income that is *not* taxable under state tax law and adding back income that *is* taxable, to arrive at *California*

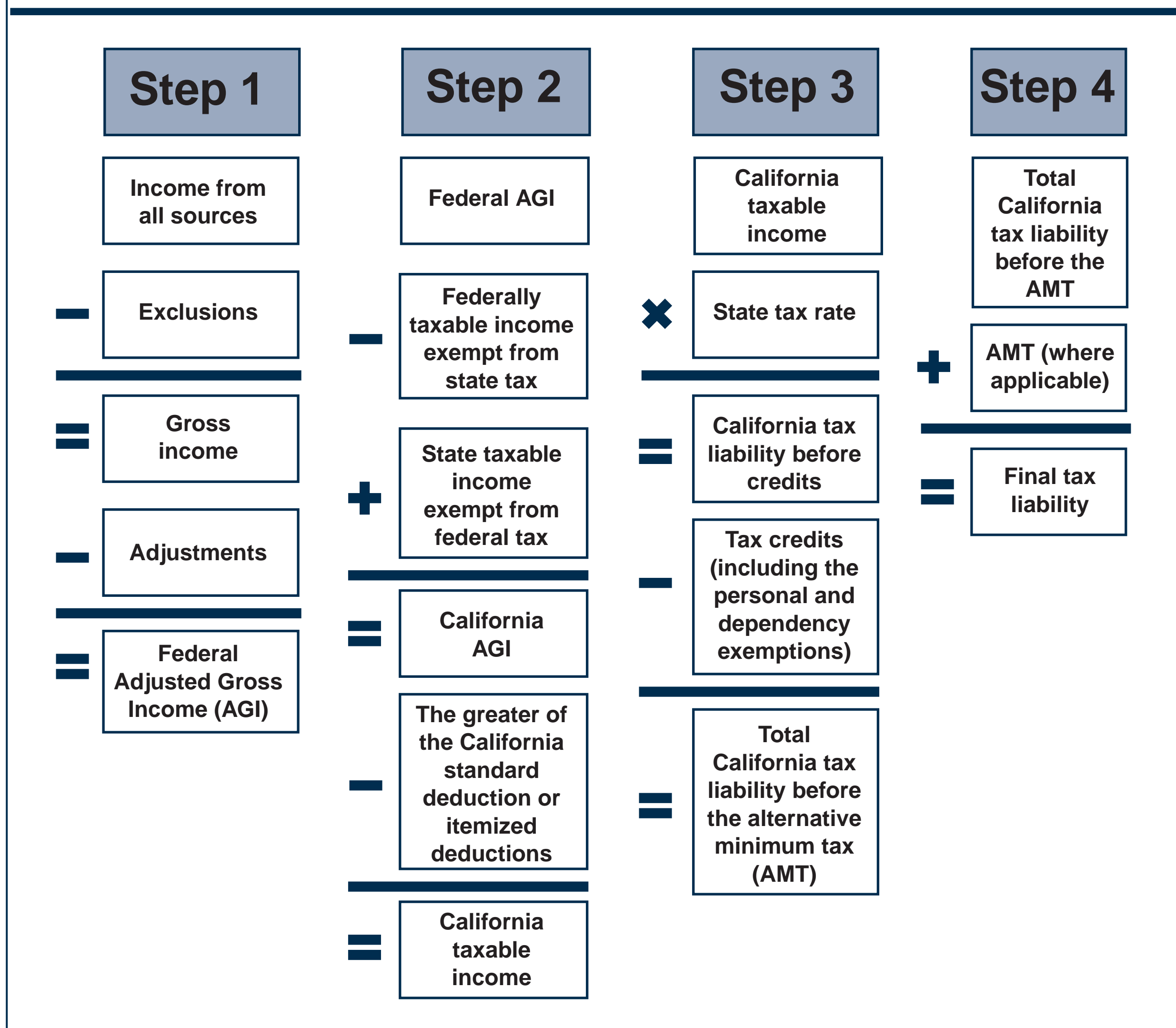

Figure 1

Determination of California Personal Income Tax Liabilities

A G I .

Taxpayers are then allowed to deduct from their California AGI the larger of either a fixed dollar amount (called the “standard deduction”) or the total amount of their allowable itemized expenditures of specified types (called “itemized deductions”), to arrive at California *taxable income* (TI).

- **Step 3—California Tax Liability.** Tax rates are then applied to California TI to arrive at state PIT liability before credits. Taxpayers are allowed tax credits of certain types which are directly subtracted from their pre-credit tax liability. For most taxpayers, the resulting amount reflects their *income tax liability*.

- **Step 4—Alternative Minimum Tax.** Some taxpayers may be subject to the state’s add-on *Alternative Minimum Tax* (AMT), or to having their tax credits limited under the AMT. The latter can occur if they reduce their

tax liabilities below a specified threshold amount through the use of certain TEPs or other special tax provisions. California's AMT-related provisions are intended to ensure that all taxpayers pay a minimum state tax amount, and in essence, serve to "recapture" some of the tax revenues that otherwise would be lost due to the use of tax exemptions, exclusions, deductions, and credits. California's AMT law is similar in principle to the federal AMT law, although there are some notable differences (including the AMT tax rate and tax credit restriction).

Marginal Tax Rates and Income Tax Brackets. The tax rates used to calculate state PIT liabilities depend on both the *filing status* and *taxable income* of the taxpayer. California has five filing statuses: single, married filing jointly, married filing separately, head of household, and surviving spouse with dependents. A different tax rate schedule is used for each filing status. In general, taxpayers must use the same filing status on both their federal and state tax returns. Over 84 percent of all California tax returns filed are from taxpayers selecting the married filing jointly or the single filing statuses.

As noted above, each filing status has a corresponding tax rate schedule. Figure 2 provides tax rate schedules by filing status for the 1998 tax year. As Figure 2 shows, under California's progressive income tax rate structure, taxpayers at higher income levels pay a larger share of their income in taxes than do taxpayers at lower income levels. In 1998, marginal tax rates ranged from 1 percent to 9.3 percent, with an AMT rate of 7 percent. To calculate their state tax liability before credits, taxpayers use the tax rate schedule that corresponds to their appropriate filing status. For example, a single taxpayer with taxable income of $28,500 would have a state tax liability of $920.25 + (8 percent x $1,856.00), or $1,068.73. California indexes its PIT brackets annually for inflation using the June- (of the prior year) to-June (of the current year) increase in the California Consumer Price Index. California's standard deduction and personal and de-

Figure 2

Personal Income Tax Rate Schedules for 1998

If the taxable income is:					
Over	But Not Over	Computed Tax Is			Of The Amount Over
Married Filing Jointly and Surviving Spouses with Dependents					
$0	$10,262	$0.00	+	1.0%	$0
10,262	24,322	102.62	+	2.0	10,262
24,322	38,386	383.82	+	4.0	24,322
38,386	53,288	946.38	+	6.0	38,386
53,288	67,346	1,840.50	+	8.0	53,288
67,346	and over	2,965.14	+	9.3	67,346
Single and Married Filing Separate					
$0	$5,131	$0.00	+	1.0%	$0
5,131	12,161	51.31	+	2.0	5,131
12,161	19,193	191.91	+	4.0	12,161
19,193	26,644	473.19	+	6.0	19,193
26,644	33,673	920.25	+	8.0	26,644
33,673	and over	1,482.57	+	9.3	33,673
Head of Household					
$0	$10,264	$0.00	+	1.0%	$0
10,264	24,323	102.64	+	2.0	10,264
24,323	31,353	383.82	+	4.0	24,323
31,353	38,803	665.02	+	6.0	31,353
38,803	45,833	1,112.02	+	8.0	38,803
45,833	and over	1,674.42	+	9.3	45,833

Source: Franchise Tax Board.

pendent credits also are indexed for inflation.

Because the tax brackets for single persons are divided at levels that are exactly half of their married-filing-joint counterparts, California's income tax bracket structure generally does *not* result in a "marriage penalty." (At the federal level, this penalty can occur when two single taxpayers with equal incomes are subject to lower tax liabilities than are two similar taxpayers who are married.) California's tax system results in either marriage neutrality or, for many taxpayers, actual marriage *bonuses.*

Effect of Different Marginal Tax Rates. In many of the reviews of TEPs relating to PIT, we indicate that the program results in disproportionate benefits to higher-income taxpayers due to their higher marginal tax rates. It is important to note why this happens, since its occurrence is so frequent in TEPs which result in either deductions or exclusions from income.

An example of this is a married couple filing jointly with California taxable income (TI) of $75,000. Their marginal tax rate is 9.3 percent and tax liability before credits is $3,676.96. Now assume the couple has a deduction for mortgage interest payments of $5,000. This would result in TI of $70,000 and a tax liability of $3,211.96, or $465 less than their liability without the deduction.

Alternatively, a married couple filing jointly with a California TI of $50,000 has a marginal tax rate of 6 percent, and a pre-credit tax liability of $1,643.22. With a mortgage interest deduction of $5,000, their tax liability would drop to $1,343.22, or $300 less than their tax liability without the deduction.

Based on this example, in terms of taxes saved, the deduction is worth $165 more to the higher-income couple. A similar result occurs when income *exclusions* are involved.

BANK AND CORPORATION TAX

Most corporations that earn income derived or attributable to California sources are subject to California's BCT. Some corporations, however, are either *exempt* or *partially exempt* from the tax. These include insurance companies (which are subject to a gross premiums tax in lieu of a tax on net income) and nonprofit organizations (which are only subject to the BCT for earned income that is unrelated to their tax-exempt status).

Types of Bank and Corporation Taxes. There are four basic categories of taxes levied under the BCT:

- ***Franchise Tax.*** Most California corporations are subject to the franchise tax, which is levied for the privilege of conducting business in California. For most corporations, a flat 8.84 percent tax rate is applied to the corporation's *net* income attributable to California to arrive at pre-credit state tax liabilities. Subchapter S corporations are subject to an entity-level tax at the reduced rate of 1.5 percent. A variety of tax credits are available to BCT taxpayers, as discussed in the TEP reviews which follow.

  The franchise tax accounts for the majority of revenues raised under the BCT, and generally is the tax being referred to when the term "corporate income tax" is used (even though there is a separate smaller corporate income tax, as discussed below). As under PIT, corporate taxpayers who take advantage of certain tax preferences or special tax provisions must complete an AMT calculation and pay any resulting amount by which it exceeds the amount of the regular tax due. For 1998, the AMT tax rate is 6.65 percent.

- ***Corporate Income Tax.*** Corporations that derive income from California sources but do *not* have a substantial enough presence to be classified as "conducting business" in the state are subject to the corporate *income* tax.

(Business trusts are also taxable under this tax.) Very few corporations actually file under the corporate income tax. This tax is levied in a manner similar to the corporate franchise tax; however, there are a number of provisions unique to it. (For example, businesses that file under the corporate income tax are not subject to the state's minimum tax [see below] and also may exclude income from tax-exempt securities.)

- ***Minimum Franchise Tax.*** Corporations that have less than an $800 annual computed franchise tax liability, or no computed tax liability at all, must pay a minimum franchise tax of $800. *New* corporations with gross income under $1 million pay a reduced minimum tax of $300 the first year and $500 the second year. In recent years, the minimum tax has applied to the majority of California corporations because their computed tax liabilities are below the minimum tax threshold. For example, in 1996, 325,000 of the 430,800 total corporate tax returns that were filed (or 75 percent) were subject to the minimum tax.
- ***Bank Tax.*** Banks and other financial institutions are subject to an "add-on" tax that is levied in addition to the franchise tax. This tax is paid in lieu of personal property taxes and local business taxes. Under current law, the add-on portion of the bank tax rate is 2 percent. (Prior to 1996, the rate was set annually by the FTB to be equivalent to the average amount of personal property and local business taxes paid by corporations.) Thus, banks and other financial institutions are subject to a total corporate tax rate of 10.84 percent.

Figure 3 provides a history of California BCT rates levied since the tax was created in 1929. As it shows, the current general franchise tax rate is at its lowest level since 1973. Other state corporate-related tax rates—such as for Subchapter S corporations, the corporate AMT, and banks and financial corporations—have generally declined in recent years as well. However, the corporate minimum tax has remained at $800 for most corporations since 1990.

Figure 3

Bank and Corporation Tax Rates

	General Corporation Rate	Minimum Tax[a]
1929-34	2.00%	$25
1935-42	4.00	25
1943-49	3.40	25
1950-58	4.00	25
1959-66	5.50	100
1967-71	7.00	100
1972	7.60	200
1973	8.30	200
1974-79	9.00	200
1980-81	9.60	200
1982-86	9.60	200
1987-88	9.30	300
1989	9.30	600
1990-96	9.30	800
1997 to present	8.84	800

[a] Beginning in 1998, new small corporations pay a minimum tax below this amount.

Source: Franchise Tax Board.

Calculation of Income for Multistate and Multinational Corporations. If a corporation derives *all* of its income from California sources, the entire nonexempt portion of income is used in the state BCT liability calculation described above. However, if the corporation has multistate or multinational operations and has business income attributable to non-California sources, then it must *apportion* the amount of its *business* income attributable to its California operations. *Nonbusiness* income, such as interest and royalties, is allocated to (1) the corporation's official state of residence, in the case of taxable income

derived from intangibles, or (2) where relevant property is located, in the case of taxable income derived from real or personal property.

Before apportioning income, the corporate taxpayer must first identify the extent of its operations that are attributable to a corporation or group of corporations operating as one integrated business. This taxpayer may elect to combine either: (1) its *worldwide* income or, (2) its income *within* the U.S. and certain specified "tax havens." The former method is known as the "worldwide" basis and the latter as the "water's-edge" basis. Once this election is made, formula apportionment (see below) is used to determine the portion of income attributable to California for tax purposes.

Formula Apportionment. California's apportionment formula is based on looking at a firm's average ratio of its corporate activity in California to its total corporate activity (either on a worldwide basis or water's-edge basis, depending on the taxpayer's preference) for three factors: property, payroll, and sales. In California, the sales factor is double-weighted (except for mining and other extractive industries, agriculture, and banking and financial business activity). The average computed ratio is then multiplied by the total net corporate income (whether on a worldwide basis or water's-edge basis) to arrive at the amount of income attributable to California. This amount is then used in the calculation described above to arrive at corporate state tax liabilities.

Because the sales factor is weighted twice in computing the apportionment factor (versus the alternative approach of equally weighting all three factors), certain corporations are advantaged. Specifically, the formula provides relative benefits to those corporations that are based in California but conduct most of their sales outside of the state. This procedure serves to encourage and stimulate California-based development and production activities.

Calculation of Income Tax Liabilities. Corporations may choose to file their taxes based upon either a calendar-year or fiscal-year basis (which in the latter case, commences in any month other than January). Corporations calculate tax liabilities based upon a process similar to that described above for PIT filers. First, all income attributable or sourced to California must be added up, and then tax-exempt or excluded income is subtracted from this amount to arrive at *gross* income. Next, deductions are subtracted to arrive at a measure of corporate *net* income. For most corporations, the flat 8.84 percent tax rate is levied on this net income, yielding state BCT liabilities before tax credits. Certain tax credits may reduce corporate tax liabilities. However, as noted above, corporations are subject to the state's AMT, which serves to recapture some of those tax revenues that would otherwise be lost due to tax exemptions, exclusions, deductions, and credits.

Exclusion/Exemption:

CAPITAL GAINS ON INHERITED PROPERTY

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Sections 18031 and 18036, which partially conform to Internal Revenue Code Section 1014.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	*PIT*
1996-97	*$575*
1997-98	*610*
1998-99	*650*

DESCRIPTION

This program exempts from capital gains taxation the appreciation in the value of property which has occurred prior to the transfer of the property from a decedent to an heir. Thus, the heir's "basis" in the property, from which capital gains eventually will be measured, is adjusted upward to equal the property's fair market value at the time of the decedent's death. Accordingly, taxes on the capital gains that materialize prior to the transfer of property to heirs are permanently forgiven.

RATIONALE

This program provides tax relief to heirs who inherit property that has appreciated in value while held by the deceased. The original rationale for this program was that inherited property was itself subject to taxation; thus, some argued that subjecting inherited capital gains to taxation would amount to a form of "double taxation."

It also is frequently argued that, without this program, heirs might need to sell their inherited property to pay the tax on previously accumulated capital gains.

COMMENTS

California eliminated its inheritance tax in 1982 pursuant to Proposition 6. The state's current taxes on inherited property—the estate tax and the generation-skipping transfer tax—do not impose any real tax burden on California taxpayers, since both represent so-called "pick-up" taxes. This type of tax simply collects a state tax that would otherwise go to the federal government by taking maximum advantage of the federal estate tax credits that are granted to Californians for their state death-related taxes paid. Thus, the tax imposes no additional cost to these California taxpayers. The double taxation rationale, therefore, no longer applies.

The concern that heirs might need to sell their inherited property in order to pay capital gains taxes could be dealt with directly by a tax-deferral program. A tax-forgiveness program is not necessary to address this particular concern.

Exclusion/Exemption:

CAPITAL GAINS ON THE SALE OF A PRINCIPAL RESIDENCE

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Sections 17131 and 17152, which generally conform to Internal Revenue Code Section 121.*

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	***PIT***
1996-97	*—*
1997-98	*$485*
1998-99	*750*

DESCRIPTION

For sales and exchanges of residences occurring after May 6, 1997, California law allows the taxpayer to exclude from gross income the gain realized on the sale or exchange up to a maximum amount. The exclusion is allowed if the taxpayer used the residence as a principal residence for two of the previous five years. The subsequent purchase of another residence is not required. The exclusion for a given sale is limited to $250,000 for single income tax filers and $500,000 for married taxpayers filing jointly. Exclusions can be claimed for additional sales or exchanges providing the above conditions are met. California law waives a portion of the two-year occupancy rule for Peace Corp volunteers. Additionally, it does not conform to federal transitional provisions which allow certain taxpayers to elect prior tax treatment for certain sales.

RATIONALE

This program provides tax relief to homeowners who sell their residences. There are two apparent rationales for the program. First, in the case where the sale of a residence is entirely or largely involuntary, due to such factors as changing employment or family circumstances, the program avoids putting an additional financial burden on certain households faced with acquiring replacement housing.

Second, the program provides an incentive for households to invest more of their resources in owner-occupied housing than they otherwise would. This is because the program reduces the overall costs of home ownership, and thus raises its overall rate of return as an investment. This is especially true when housing is compared to those other investments whose capital gains are subject to taxation.

DISTRIBUTION OF BENEFITS

This program primarily benefits higher income taxpayers. As shown in the accompanying table, about 85 percent of the total benefits go to those earning in excess of $100,000 annually, and almost two-thirds goes to those earning $150,000 or more. The average amount claimed also generally increases for those with higher incomes. The reduction in the average amount claimed for those in the highest income category is a result of limitations on the amount of the capital gain that can be excluded for tax purposes.

Capital Gains on the Sale of a Principal Residence Exclusion

1998 Tax Year

Adjusted Gross Income ($000)	Percent of Total Taxpayers Benefitting	Percent of Total Amount Claimed	Average Amount Claimed
$0-20	—	—	—
20-40	1.2%	0.3%	$338
40-60	4.9	1.5	487
60-80	18.3	6.8	621
80-100	15.6	6.8	727
100-150	27.4	21.5	1,302
150-200	14.6	21.6	2,463
200-250	7.3	13.5	3,078
250-500	8.2	24.1	4,925
Over 500	2.6	4.1	2,674

Comments

This program is a liberalized extension of the previous capital gains exclusion which both state and federal law allowed for capital gains on sales of residences. Specifically, for sales and exchanges occurring on or prior to May 6, 1997, there was a one-time exclusion granted to taxpayers over age 55 of up to $125,000 for married couples filing jointly and single taxpayers, and up to $62,500 for married taxpayers filing separately. This program also replaces the deferral of capital gains available to taxpayers who sold a principal residence. To qualify for the deferral, another principle residence of equal or greater value had to be acquired within two years of the date of sale.

The change from the more-limited exclusion and deferral programs to the more-generous provisions incorporated in the current program may result in a one-time "unlocking" effect, stimulating a shift toward nonhousing investments on the part of certain homeowners.

Overall, however, this provision makes housing a relatively more attractive investment than it otherwise would be when compared to alternative types of investments. This is because the exclusion essentially raises the economic "rate of return" on housing by reducing the taxes which eventually have to be paid on a residence. Although the previous capital gains exclusion program noted above also raised the rate of return on housing investments, the more-generous provisions of this current program have a stronger effect in this regard.

Exclusion/Exemption:

CAPITAL GAINS FROM HOUSING SALES TO LOW-INCOME RESIDENTS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).* *Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 18041.5 and 24955.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	*PIT*	*BCT*
1996-97	—	*NA*
1997-98	—	*NA*
1998-99	—	*NA*

DESCRIPTION

This program allows taxpayers to exclude from taxable income their capital gains from the sale of government-assisted low-income housing units to low-income tenants. In order to qualify for the exclusion, a majority of the housing units sold must remain in use by low-income tenants for either 30 years from the date of sale or for the remaining term of existing federal government financial assistance, whichever is longer. In addition, the taxpayer must reinvest all of the proceeds from the sale in residential property other than a personal residence. The taxpayer's "basis" in the new residential property is reduced by the amount of the gain from the sale. Thus, the program provides for a tax *deferral* rather than permanent tax forgiveness.

RATIONALE

This program provides an incentive for owners of low-income housing that has been subsidized by the federal government to sell the property to low-income tenants for continued use as low-income housing, rather than sell it for, or convert it to, other purposes upon termination of the federal subsidy. It does this by providing for a tax deferral on the gain from that sale. This deferral of the tax liability amounts to an interest-free loan from the government, which increases the economic gain from the property sale.

COMMENTS

The estimated PIT revenue effects for this program are not directly available. Rather, the estimates are included within the estimates for "Capital Gains on The Sale of a Principal Residence." The BCT estimates are not available due to the lack of comparable federal data upon which to base these estimates.

In the 1960s, the federal government provided low-interest loans and rent subsidies through various programs administered by the federal Housing and Urban Development Department (HUD) and Farmers' Home Administration (FHA). In return, private developers and property owners agreed to build or operate rental projects which were protected by low-income use restrictions. In order to stimulate private sector participation, the owners were given the option to terminate their contracts prior to their loan maturity dates. As owners exercise their options to sell and/or as federal subsidy periods expire, the housing units may be sold or converted to market-rate units, thereby displacing low-income tenants and reducing the state's supply of affordable low-income housing. This

program aims to lessen the extent to which this occurs.

The original state program was created by Chapter 1436, Statutes of 1990 (SB 1286, Seymour).

Exclusion/Exemption:

EMPLOYER-SPONSORED EDUCATIONAL ASSISTANCE PROGRAMS

Program Characteristics

Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Section 17151, which partially conforms to Internal Revenue Code Section 127.

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT
1996-97	$6
1997-98	4
1998-99	4

DESCRIPTION

This program allows taxpayers to exclude from their gross income contributions made to qualified educational assistance programs by their employers on their behalf. The amount which may be excluded under this program is limited to $5,250 annually. In order to qualify for this exclusion, the educational program must be provided for the exclusive benefit of employees and their dependents, and comply with various federal rules to ensure nondiscrimination in favor of highly compensated employees. The exclusion is inapplicable to graduate level courses commencing after June 30, 1996.

RATIONALE

This program provides an incentive for employers to provide, and employees to accept, contributions to educational assistance programs in lieu of taxable monetary compensation. This is because a given level of contributions is worth more to employees on an after-tax basis than an equivalent amount of taxable income. The program represents a policy designed to encourage additional consumption of education and stimulate an increase in human capital formation.

COMMENTS

This program conforms to an identical federal program, except that the federal program provides an exclusion only through June 1, 2000. In contrast, California law has no sunset provision.

Exclusion/Exemption:

UNEMPLOYMENT INSURANCE BENEFITS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Section 17083.*

Estimated Revenue Reduction
(In Millions)

Fiscal Year	PIT
1996-97	$63
1997-98	58
1998-99	53

DESCRIPTION

This program exempts unemployment insurance benefits from the recipient's gross income for tax purposes.

RATIONALE

Various reasons are mentioned for the tax relief provided by this program. One is that legislatively provided social welfare benefits should not be taxed, since they often are structured by policymakers with the intent of providing specific amounts of purchasing power to recipients. Another is that paying taxes on such benefits could be an especially onerous burden on jobless individuals, who often have trouble paying for such basic necessities as housing, food, and clothing.

COMMENTS

State law does not conform to federal provisions, as contained in the 1986 Federal Tax Reform Act, which require certain taxpayers to *include* their unemployment compensation as gross income. The intent of the federal requirement is to treat government-paid unemployment benefits more like privately provided unemployment compensation benefits. The latter are fully taxable to recipients in California to the extent that they exceed prior contributions.

The subsidy provided by the program is worth disproportionately more to higher-income taxpayers than lower-income taxpayers, due to the former's higher marginal income tax rates. Economists argue that a side-effect of this program is that it may provide a disincentive for certain unemployed persons to seek jobs, since it reduces the after-tax cost of being unemployed. This could be particularly relevant in such cases as unemployed spouses of moderate-to-high-income taxpayers, whose economic need for employment may be less than that of lower-income individuals.

Exclusion/Exemption:

EMPLOYER CONTRIBUTIONS TO ACCIDENT AND HEALTH PLANS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Section 17131, which conforms to Internal Revenue Code Section 106.*

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	***PIT***
1996-97	*$1,690*
1997-98	*1,800*
1998-99	*1,910*

DESCRIPTION

This program excludes employer contributions to accident and health plans from the gross income of employees for tax purposes.

RATIONALE

This program provides tax relief to all individuals whose employers contribute to the costs of accident and health plans that provide compensation for sickness and injury.

It is argued that the program provides both employers and employees with an incentive to make accident and health insurance a standard part of the employees' compensation packages. Program supporters argue that this is a desirable social goal, because it provides security to workers, increases productivity, and reduces the need for the government itself to provide accident and health care programs.

An additional rationale for continuing this program is that paying taxes on these non-cash benefits would impose a financial hardship on many taxpayers.

DISTRIBUTION OF BENEFITS

Tax benefits under this program are concentrated in the middle income groups. As shown in the accompanying table, over 50 percent of exclusions accrue to taxpayers with annual income of $60,000 or less, and over 70 percent go to taxpayers earning $80,000 or less. Very little of the benefits go to taxpayers earning $20,000 or less, due in part,

Employer Contributions to Accident And Health Plans Exclusion

1998 Tax Year
(Dollars In Millions)

Adjusted Gross Income ($000)	Total Amount Claimed	Percent of Total
$0-20	$16	0.8%
20-40	442	23.2
40-60	507	26.6
60-80	372	19.5
80-100	238	12.5
100-150	200	10.5
150-200	59	3.1
200-250	39	2.0
250-500	21	1.1
Over 500	15	0.8

to the fact that individuals in this income class are more likely than those in higher-income categories to have jobs which do not include paid benefits. Over 80 percent of the exclusions from this program go to married joint filers and heads of household.

COMMENTS

According to a February 1997 U.S. General Accounting Office (GAO) study, approximately two-thirds of Americans under the age of 65 have employment-based health insurance. The GAO estimates that in 1993, three-quarters of the workforce participated in employer-subsidized plans such as those that qualify under this program. The GAO also found that as the costs of providing health insurance have increased, the number of individuals with employer-based coverage has declined over the last few years.

The consensus view of economists is that state and federal programs like this one have contributed significantly to shifting the mix of employee compensation away from wages and salary income in favor of nonmonetary fringe benefits. In fact, some economists believe that the subsidy provided by these programs has reduced the after-tax cost of health care to such a degree that there is excessive use of health care services by those with employer-subsidized health plans. To the extent that this is true, these programs can result in a misallocation of economic resources and the escalation of health care costs.

In recent years, however, structural changes made to many employer-based health insurance programs have resulted in increased health-related costs being borne by the consumer, either through higher deductibles, greater premium payment contributions, per visit charges, or some combination of these factors. To the extent that resource misallocations involving health-care benefits have occurred in the past, the effect of the above-noted increases in health-care usage costs to the consumer should help mitigate the inefficiencies and misallocations associated with the favorable tax treatment of employer-based health insurance programs.

Generally speaking, the health-care benefits under this program provide proportionately greater benefits to higher-income taxpayers than to lower-income taxpayers. This is because higher-income taxpayers typically face higher marginal income tax rates, which in turn makes a given dollar exclusion under this program worth more to them than for a lower-income taxpayer. In addition, higher-income taxpayers have been shown to participate in employer-subsidized health care plans to a greater extent than do lower-income taxpayers.

Exclusion/Exemption:

EMPLOYER CONTRIBUTIONS TO PENSION PLANS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Section 17501, which conforms to Internal Revenue Code Sections 401 through 404a.*

Estimated Revenue Reduction
(In Millions)

Fiscal Year	PIT
1996-97	$2,400
1997-98	2,500
1998-99	2,610

DESCRIPTION

This program excludes employer contributions to qualified retirement plans and simplified employee pension plans (SEPs) from the gross income of employees, subject to certain conditions. (Employees do, however, eventually have to pay tax on that portion of the retirement benefits they receive which was funded through employer contributions.) In general, for defined contribution plans, the allowable annual addition to a participant's account that can be excluded from gross income is limited to the lesser of 25 percent of the taxpayer's compensation, or $30,000.

RATIONALE

This program provides tax relief to persons who receive income in the form of employer contributions to their pension plans. This tax relief is in the form of a tax *deferral*, since these persons eventually are subject to paying taxes on the retirement benefits they receive. The underlying rationale for the program is the view that employees should not have to pay taxes on income until this income actually is received by the employee.

DISTRIBUTION OF BENEFITS

Generally, the tax benefits associated with this program are distributed over a wide range of income classes, excluding the very lowest. As shown in the accompanying table, almost one-third of the claims are by taxpayers with annual earnings of $80,000 or less, with over half going to those earning $150,000 or less. Those taxpayers earning more than $500,000 annually receive almost one-quarter of the exclusions, however, even though they constitute fewer than one percent of returns.

Employer Contributions to Pension Plans Exclusion

1998 Tax Year
(Dollars In Millions)

Adjusted Gross Income ($000)	Total Amount Claimed	Percent of Total
$0-20	$29	1.1%
20-40	196	7.5
40-60	306	11.7
60-80	287	11.0
80-100	243	9.3
100-150	345	13.2
150-200	185	7.1
200-250	201	7.7
250-500	194	7.4
Over 500	623	23.9

COMMENTS

In the long run, the tax deferral provided by this program has a net cost to the state. This is because most persons are in lower marginal income tax brackets after retirement, compared to their marginal income tax brackets during their working years when their employers were contributing to their retirement plans. In addition, the "present value" of the deferred taxes paid in later years is less than the value of the taxes that the state would have received if they had been paid at the time the employer contributions were made, due to such factors as inflation. Generally, the structure of retirement programs, especially arrangements in which employers "match" the contributions made by employees, encourage a greater rate of participation and contributions than would have otherwise occurred.

Exclusion/Exemption:

SOCIAL SECURITY AND RAILROAD RETIREMENT BENEFITS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Section 17087.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT
1996-97	$800
1997-98	825
1998-99	850

DESCRIPTION

This program exempts social security benefits and federal railroad retirement benefits from the recipient's gross income for tax purposes.

RATIONALE

This program provides tax relief to social security and railroad retirement recipients. The apparent rationale is a desire to protect the retirement income of elderly or disabled individuals who may have high living expenses due to illness or infirmity.

COMMENTS

Federal law under Internal Revenue Code Sections 72(r), 86, and 105(h), provides for the *partial* taxation of social security and railroad retirement benefits. For most taxpayers, the amount of these benefits that must be reported as income for federal tax purposes equals the lesser of one-half of the benefits received, or one-half of the excess of the taxpayer's combined income (as defined) over a specified base amount. For 1998, the base amount is $32,000 for married taxpayers filing jointly. However, for high income taxpayers, up to 85 percent of social security and railroad retirement benefits may be included as income.

The partial taxation of these benefits at the federal level was adopted to put social security benefits more on a par with other types of pension benefits, which are taxable only to the extent that the annuity or pension received exceeds a taxpayer's own direct pension-related contributions.

Because a given dollar exclusion of social security benefits from state income for tax purposes is worth more to taxpayers as their marginal income tax rates rise, social security recipients with higher amounts of taxable income from other sources realize disproportionate benefits from this state program.

Exclusion/Exemption:

EMPLOYER CONTRIBUTIONS FOR LIFE INSURANCE

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Section 17081, which conforms to Internal Revenue Code Section 79.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**PIT**
1996-97	$65
1997-98	65
1998-99	65

DESCRIPTION

This program exempts from an employee's gross income that portion of the employer's contributions to his/her group term life insurance policy associated with the first $50,000 in individual coverage. Also exempt are contributions to life insurance policies which specify that the beneficiary is no longer employed by the employer providing coverage and is disabled, or the beneficiary is the employer or a charitable organization. In addition, insurance contributions under a qualified pension or profit-sharing plan are tax exempt.

RATIONALE

This program, by subsidizing the cost of life insurance, provides tax relief to policyholders and an incentive for employees and employers to incorporate life insurance coverage into their compensation packages. According to federal reports, the original rationale for the federal program (to which California conforms) was two-fold. First, it was believed that there were difficulties in properly apportioning group life insurance premium costs among individual employees, since premium costs depend on such factors as age, health, and related mortality factors. Second, it was believed that life insurance benefits would help keep family units intact upon death of the primary wage earner.

COMMENTS

Higher-income taxpayers benefit disproportionately under this program, both because of their higher marginal income tax rates and because employer-paid life insurance is most commonly provided for more highly compensated management-level employees.

Life insurance proceeds themselves are not taxed (see "Proceeds from Life Insurance and Annuity Contracts"). Thus, the provision of life insurance as a fringe benefit is completely tax exempt for many individuals. However, life insurance purchased by self-employed individuals, or by individuals whose employers do not make premium contributions, receive no tax break comparable to this program.

Exclusion/Exemption:

PROCEEDS FROM LIFE INSURANCE AND ANNUITY CONTRACTS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).* *Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17081, 17131, 17132.5, 24302, and 24305, which generally conform to Internal Revenue Code Sections 72 and 101.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	*PIT*	*BCT*
1996-97	*$690*	*$36*
1997-98	*710*	*36*
1998-99	*730*	*36*

DESCRIPTION

This program generally allows an exclusion from gross income for proceeds received by a beneficiary from the life insurance policy of a deceased person. (Any *interest* component of such proceeds received as installments *is* taxable, however, and must be included in the recipient's gross income.) If the proceeds are received under circumstances other than death, then only the actual investment in the contract (for example, the aggregate premium and any other consideration paid) is excludable from gross income.

Beginning in 1991, Chapter 1387, Statutes of 1990 (AB 2663, Peace), makes amounts received under a "living benefits" contract excludable from gross income. These types of contract arrangements involve situations in which the insured, under a life insurance policy, has a catastrophic or life-threatening illness or condition. In such an event, the policy owner can give up or transfer the right to receive death benefits under the policy in exchange for compensation amounting to less than the death benefits.

RATIONALE

This program provides tax relief to persons who have been designated as beneficiaries of deceased persons' life insurance policies. To the extent that these beneficiaries were financially dependent on the deceased, the program helps to stabilize their economic situations. The program also provides financial relief to individuals receiving accelerated benefits due to catastrophic or life threatening illness, thereby helping them cope with the financial hardships that often are associated with such illnesses.

COMMENTS

Higher-income individuals are likely to benefit disproportionately from this program, since insurance coverage tends to be positively correlated with income, and high-income taxpayers are in the highest marginal income tax brackets.

Due to a developing market involving the "sale" of insurance policies to investors, the rationale related to financial dependence of beneficiaries has been weakened. The sale of insurance policies generally requires that the

investor pay the remaining premiums in exchange for being named the beneficiary of the policy. Proceeds received pursuant to the sale of an insurance policy would be subject to taxation.

With few exceptions, California has been in conformity with federal law since 1987.

Exclusion/Exemption:

INTEREST ON GOVERNMENT DEBT OBLIGATIONS

Program Characteristics	
Tax Type:	Personal Income Tax (PIT). Bank and Corporation Tax (BCT).
Authorization:	California State Constitution, Article XIII, Section 26(b), and California Revenue and Taxation Code Sections 17088, 17133, 17143, 17145, and 24272, which partially conform to Internal Revenue Code Sections 103 and 852.

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT	BCT
1996-97	$320	Minor
1997-98	350	Minor
1998-99	380	Minor

DESCRIPTION

This program exempts from gross income the interest income earned on certain debt obligations issued by the U.S. government, territories of the United States, Puerto Rico, certain federal agencies, and California state and local government entities. The interest received from a mutual fund also is tax exempt if government obligations (those of California state and local governments and the federal government) comprise 50 percent or more of the fund's portfolio or of a series of assets within the portfolio. While the interest on qualifying debt obligations is tax exempt, any capital gains on the sale of such tax-exempt obligations must be reported as income.

The program applies to both PIT and the corporate *income* tax, but *not* to the corporate *franchise* tax.

RATIONALE

This program subsidizes the costs of governmental borrowing, by providing tax relief to investors who purchase qualifying debt obligations issued by California governments or by the federal government. This tax relief encourages investors to accept lower interest returns on these obligations which, in turn, reduces the debt-servicing costs of these debt-issuing governmental entities. In addition, the program provides an incentive for certain investors to purchase more government-issued debt than they otherwise would. As a result of these factors, governments are able to finance public outlays at lower costs than would otherwise prevail.

DISTRIBUTION OF BENEFITS

As shown in the accompanying table (see next page), the benefits from the program accrue disproportionately to high-income taxpayers. Over one-third of the claimed amount goes to the small fraction of the taxpayers earning in excess of $500,000 annually, and over one-half go to those earning more than $200,000. The average amount claimed for those in the highest income category is in excess of ten times that claimed by taxpayers in any of the lowest three income categories.

COMMENTS

The revenue figures shown above only include reductions due to outstanding California state and local obligations, and mutual fund pass-through interest dividends. No revenue-reduction amounts are included for

federal debt obligations since, pursuant to the principle of "reciprocal immunity," states are prevented from taxing the interest on U.S. government debt obligations.

Interest on Government Debt Obligations Exclusion

1998 Tax Year

Adjusted Gross Income ($000)	Percent of Total Taxpayers Benefitting	Percent of Total Amount Claimed	Average Amount Claimed
$0-20	9.6%	4.5%	$463
20-40	16.3	7.1	435
40-60	16.0	8.7	525
60-80	13.4	7.1	527
80-100	9.6	5.8	601
100-150	13.4	10.0	724
150-200	5.2	6.3	1,198
200-250	3.4	3.7	1,053
250-500	6.7	10.0	1,448
Over 500	6.5	36.8	5,614

The benefits of the tax exemption are worth proportionately more to taxpayers in higher tax brackets than those in lower tax brackets. This distinction is based on the notion of a *taxable yield equivalent*, or the effective (after tax) yield to the investor of an investment in tax-exempt securities. The taxable equivalent yield for a California municipal bond with an interest rate of 7 percent for a taxpayer in the 9 percent tax bracket would be 7.7 percent. For a taxpayer in the 2 percent bracket, however, the taxable yield equivalent would be only 7.1 percent. The greater benefits to higher-income taxpayers are even more pronounced at the federal level because of its higher marginal tax rates.

Despite the widespread use and long history of tax-exempt financing for government-issued debt, considerable controversy amongst public finance experts surrounds the continued broad-based use of programs like this. One reason for this involves the use of subsidized debt to finance projects which are not strictly "governmental" in nature, such as industrial projects and home purchases. In addition, many analysts view tax-exempt borrowing as an inequitable means of subsidizing governmental projects, since a disproportionate share of the foregone tax revenues flows to high-income investors. Finally, in order to generate sufficient market demand for the debt obligations, the interest rate on such debt is higher than the minimum required to ensure the participation of high-income taxpayers; consequently, many economists would argue that a more efficient means of aiding local governments is through various grant and loan programs. For a discussion of these and other related issues regarding this program, see *The Use of Tax-Exempt Bonds in California: Policy Issues and Recommendations*, Legislative Analyst's Office, State of California, December 1982.

Exclusion/Exemption:

COMPENSATION FOR INJURIES OR SICKNESS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Section 17131, which conforms to Internal Revenue Code Section 104.*

Estimated Revenue Reduction
(In Millions)

Fiscal Year	PIT
1996-97	$130
1997-98	135
1998-99	140

DESCRIPTION

This program allows taxpayers to exclude from their gross income the compensation they receive from workers' compensation, accident insurance, and health insurance, due to injuries or sickness. The exemption also covers the amount of any compensatory damages awarded for injury or sickness, regardless of whether the award is made under an in-court or out-of-court settlement, or whether the taxpayer receives a lump-sum award or installment payments. Punitive damages, however, are taxable. In addition, certain amounts paid by an employer to reimburse an employee for expenses incurred for the care of the employee, the employee's spouse, or the employee's dependents are excluded from taxation.

RATIONALE

This program provides tax relief to qualified taxpayers on the grounds that injuries or sickness often impose significant economic hardship, and can limit the ability of individuals to pay for such basic necessities as housing, food, and clothing. Under these conditions, taxes on compensation for injuries or sickness are viewed as a particularly onerous burden.

COMMENTS

This program covers the disability benefits received under state statute, but does not apply to amounts received as reimbursement for medical expenses claimed as income tax deductions in prior years.

Exclusion/Exemption:

EMPLOYEE DEATH BENEFITS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Sections 17131,17132.5, and 17132.6 which generally conform to Internal Revenue Code Section 101(b).*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT
1996-97	$2
1997-98	2
1998-99	2

DESCRIPTION

This program allows tax-exempt treatment for the qualified employer-provided death benefits of employees deceased *prior* to August 21, 1996, by allowing beneficiaries to exclude from their income for tax purposes up to $5,000 of noninterest-related death benefits they receive. Formerly, certain noninterest-related amounts paid by an employer to an employee's beneficiaries on account of the employee's death were nontaxable up to a total amount of $5,000, regardless of the number of employers involved. This $5,000 exclusion, however, was repealed in 1997 for both California and federal tax purposes for deaths occurring after August 20, 1996. The exclusion program continues for survivor benefits paid under certain circumstances (see "Comments").

RATIONALE

This program provides tax relief to a qualified decedent's beneficiaries with the original rationale apparently being that death benefits often are used by such individuals to adjust to the economic hardships caused by the death of decedents, and/or to cover the death-related expenses they may face (such as burial costs). However, the fact that the program no longer applies to new decedents (except as noted below), suggests that this original rationale is no longer viewed as sufficient to justify the program.

COMMENTS

Federal changes embodied in the Taxpayer Relief Act of 1997 included a provision that excludes from gross income certain survivor benefits paid as an annuity to the immediate family of a public safety officer killed in the line of duty. California incorporated this provision as a federal conformity measure through Chapter 322, Statutes of 1998 (AB 2797, Cardoza), with an effective date of January 1, 1998.

Exclusion/Exemption:

MEALS AND LODGING FURNISHED BY AN EMPLOYER

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).* *Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Section 17131, which conforms to Internal Revenue Code Section 119.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT
1996-97	$24
1997-98	24
1998-99	24

DESCRIPTION

This program allows the exclusion from gross income of the value of meals and lodging furnished by an employer (other than the military) to an employee, spouse, or dependent. To qualify for the exemption, the meals or lodging must be provided at the employer's place of business and for the convenience of the employer. In addition, for the value of lodging to be exempt, the taxpayer must be required to accept the employer-provided lodging as a condition of employment. This means that the taxpayer must accept the lodging in order to fulfill the requirements of the job.

RATIONALE

This program provides tax relief to taxpayers who are required to live in or eat at facilities which are owned by their employers. The primary rationale for the program is to simplify tax administration. For example, the value to an employee of employer-provided meals or lodging is often difficult to establish. In addition, the lodging provided by an employer may simply duplicate rather than substitute for private quarters, in which case its value to the employee could be negligible.

COMMENTS

In some cases, such as a live-in housekeeper or resident apartment manager, employer-furnished meals and lodging may represent a large portion of the employee's total compensation. To the extent that the employee's regular wages are lower as a result of this program, the government ends up subsidizing occupations that are characterized by such forms of compensation.

The program also provides an incentive for employers and employees to rely more than they otherwise would on such nonwage compensation, since the after-tax value of a dollar of this form of nonwage income is greater than that of a dollar of regular taxable wage income.

Exclusion/Exemption:

MISCELLANEOUS FRINGE BENEFITS

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Section 17131, which partially conforms to Internal Revenue Code Section 132.

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT
1996-97	$185
1997-98	200
1998-99	210

DESCRIPTION

This program provides a tax exemption to employees for specified types of employer-paid fringe benefits that they may be receiving. These benefits include: (1) special services provided to employees at no direct cost to them (such as free stand-by flights provided by airlines to their employees); (2) employee discounts for products and services sold by the employer; (3) use of company equipment (such as a company car); and (4) "de minimis" fringe benefits (such as personal use of an employer's copying machine or use of on-premises eating or gymnasium facilities).

RATIONALE

The rationale for this program depends on the type of fringe benefit involved. For instance, program supporters argue that the exemption for employer-provided gymnasium facilities is intended to provide employers with an incentive to improve the well being and productivity of their employees. The rationale for the exemption of certain other benefits often appears to be based primarily on administrative considerations, such as the difficulty of determining the value to individual employees of the specific benefit involved.

Exclusion/Exemption:

SCHOLARSHIPS, FELLOWSHIPS, AND GRANTS

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Section 17131, which conforms to Internal Revenue Code Section 117.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**PIT**
1996-97	$24
1997-98	27
1998-99	31

DESCRIPTION

This program allows taxpayers to exclude from gross income any qualifying scholarships, fellowships, and tuition grants or reductions they receive that are used for qualified educational expenses. This includes tuition and fees for enrollment and attendance at an educational institution, as well as fees, books, supplies, and equipment required for educational courses. The exclusion does not, however, apply to the portion of the scholarships, fellowships, and grants which is used to pay for room and board.

RATIONALE

The rationale for the tax relief that this program provides to the recipients of scholarships, fellowships and grants appears to relate to the problem of uniformity in the treatment of different taxpayers. According to federal sources, the related federal tax-exclusion program (to which California's program conforms) initially required that all scholarship, fellowship and grant income be included as gross income, unless the taxpayer could show that it was a gift (this is because gifts are nontaxable, as specified). However, when the Internal Revenue Code of 1954 was enacted, the present program was adopted on the grounds that it would treat all taxpayers consistently and uniformly, and eliminate the need to determine whether a "gift" was involved. Thus, the rationale for the program is that it provides equity among different taxpayers and is administratively convenient.

Another rationale offered by the program's proponents is that recipients of scholarships, fellowships and grants often are students who have limited economic resources of their own. Thus, the program helps relieve some of the economic difficulties they face and thereby encourages increased educational attainments in our society.

COMMENTS

The program applies to amounts received for such incidental expenses as travel, research, clerical assistance, and equipment, but does not apply to amounts received for teaching, research work, or similar services. In many cases the value of scholarships, fellowships, and grants is small enough that the recipients, who frequently are students with only limited outside income, would have little or no tax liabilities in the program's absence.

Exclusion/Exemption:

STATE LOTTERY WINNINGS

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Government Code Section 8880.68.

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT
1996-97	$27
1997-98	27
1998-99	28

DESCRIPTION

This program exempts from gross income any winnings from the California State Lottery.

RATIONALE

This program presumably was intended to provide a tax incentive for individuals to participate in the state lottery. It does this by increasing the "take-home" value of winnings from lottery wagering.

COMMENTS

This program was established in November 1984 by Proposition 37, which enacted the California State Lottery Act of 1984.

State lottery winnings are subject to federal income taxation, to the extent that they exceed lottery wagering losses. Gambling winnings other than lottery winnings are subject to both state and federal income taxation, to the extent that they exceed gambling losses.

Exclusion/Exemption:

INCOME FROM INVESTMENTS IN ECONOMICALLY DEPRESSED AREAS

Program Characteristics	
Tax Type:	Personal Income Tax (PIT). Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 17231, 17233, 24384.5, and 24385.

Estimated Revenue Reduction (In Millions)		
Fiscal Year	**PIT**	**BCT**
1996-97	NA	NA
1997-98	NA	NA
1998-99	NA	NA

DESCRIPTION

This program exempts from gross income the interest received from investments made in state-designated economically depressed areas, including Enterprise Zones and the Los Angeles Revitalization Zone (LARZ). For example, the interest income from a loan to a business that expands its operations in an Enterprise Zone area is tax-exempt. The loan must be used solely in connection with activities within an Enterprise Zone or LARZ, and the taxpayer must have no equity or ownership interest in the business(es) involved.

RATIONALE

This program provides an incentive for investments to be made in economically depressed areas of the state, by increasing the after-tax investment return that taxpayers can earn on loans to businesses which are located in such areas. Proponents argue that this increased rate of return may be necessary to induce investments in areas where such investments are perceived to face higher-than-average financial risks.

COMMENTS

In recent years, over two-thirds of all states have enacted some form of tax incentives for businesses operating in economically depressed areas. These incentives differ widely in their purpose and coverage. Some of the tax incentives currently made available by states include tax exemptions for businesses investing capital within a designated geographic area or zone, income tax credits based on the number of eligible employees hired by businesses in these locales, and property tax abatement programs for land and structures in such areas.

The problems of economically disadvantaged areas can take many forms, including a declining or stagnant base of economic activities, an inadequately trained or skilled labor force, a dilapidated public infrastructure involving poor-quality educational and transportation facilities, and a depressed private infrastructure involving run-down business and residential structures.

Arguments in Support. Supporters of this program argue that, given such factors, these geographic areas are worthy of financial subsidies, at least to "put them on track" to eliminate these adverse conditions. In addition, supporters argue that there often is evidence of some type of "market failure" that makes it especially difficult for these areas to deal

with their problems—including imperfect information among investors about the positive investment opportunities that these areas may offer. Thus, supporters argue, government should "get involved" to help to correct these areas' problems. They note that the benefits to be realized from such involvement include both private-sector economic gains and public-sector improvements, such as reduced crime.

Other supporters argue that, while market failures may be important to address, the program can be justified on equity grounds alone. According to this view, government-provided incentives to businesses in depressed areas can result in greater economic opportunities for the people residing in them, thereby benefitting both individual residents and the public generally.

Arguments Against. Critics of this program argue that it is an ineffective and inefficient means of stimulating new economic activity, and that it simply encourages relocation of *existing* businesses to the designated areas as opposed to the creating of truly "new" enterprises. This view holds that a "zero-sum" game is involved, with such tax incentives benefitting certain localities at the expense of others. Some critics go even further, arguing that the tax incentives represent such a small part of the cost calculation for a business that they simply constitute a "windfall benefit" for business behavior that would have occurred anyway.

Given the above, the controversy about the program's merits seems to largely revolve around the geographic scope of the program's evaluation, for example, whether the focus is on the economic effect on the targeted impact area *alone* or the change in the level of economic activity for the state or a region as a *whole*. Supporters argue that even if the program does not increase economic activity for the state generally, it still is justified on distributional grounds if it benefits a particular disadvantaged area. They also note that there may be efficiency gains resulting from relocating investment from high-employment labor markets to low-employment labor markets, as otherwise under-utilized resources are tapped.

Empirical Evidence. Empirical evidence is mixed as to the efficiency and effectiveness of this and similar programs. For example, in *What Do We Know About Enterprise Zones?* (Tax Policy and the Economy, Volume 7, National Bureau of Economic Research, 1993), evidence is presented of increased investment and reduced unemployment claims within enterprise zones in Indiana. Also, a report prepared for the New Jersey Department of Commerce that surveyed firms receiving such tax incentives found that about one-third said they were the sole or major factor in their investment decision (see Rubin and Armstrong, *The New Jersey Enterprise Program: An Evaluation*, 1989). However, data from the U.S. Census Bureau indicates that the economic well-being of enterprise zone residents has not significantly improved since the zones were established.

The California Bureau of State Audits (BSA) conducted a review of the effectiveness of the employment and economic incentives of California enterprise zones and program areas (a former state program). Based on statistics provided by the California Employment Development Department, the BSA found that business and job growth in the enterprise zones and program areas generally exceeded the growth in the counties in which they were located. However, the BSA was unable to determine whether this growth was the result of tax incentive programs per se versus other factors (see California Trade and Commerce Agency, *The Effectiveness of the Employment and Economic Incentive and Enterprise Zone Programs Cannot Be Determined*, November 1995).

Exclusion/Exemption:

FOSTER CARE PAYMENTS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Section 17131, which partially conforms to Internal Revenue Code Section 131.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT
1996-97	$2
1997-98	2
1998-99	2

DESCRIPTION

This program allows taxpayers to exclude from gross income the payments they receive from state, local, and nonprofit agencies as reimbursement for the costs of taking care of a foster child. To qualify, a foster child must live in the taxpayer's home.

RATIONALE

This program provides an incentive for individuals to take on the responsibilities of caring for foster children. The payments and tax exclusion are intended as compensation for and to cover expenses associated with foster care.

COMMENTS

Supplemental payments made by the state or a tax-exempt child-placement agency as "difficulty-of-care payments," are also excludable from gross income for tax purposes. These are intended as compensation for the additional expense associated with the care of a foster child with a physical, mental, or emotional handicap.

Exclusion/Exemption:

EMPLOYEE RIDESHARING BENEFITS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Sections 17090 and 17149, which partially conform to Internal Revenue Code Section 132.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program allows taxpayers to exclude from their gross income the compensation or any other benefits they receive from an employer for their costs of participating in a qualified ridesharing program. The exemption covers compensation or other benefits received for commuting in a third-party vanpool, private commuter bus, or subscription taxipool, and for monthly transit passes that are used by an employee or the employee's dependents. It also covers such benefits as carpooling, free or subsidized parking, bicycling, ferry use, travel to or from a telecommuting facility, and any alternative transportation method that reduces the use of motor vehicles in traveling to or from a place of employment.

RATIONALE

This program provides tax relief to employees who participate in ridesharing programs, and an incentive for employers to make ridesharing benefits a part of their employees' overall compensation. The program's underlying rationale is based on the view that state tax incentives are needed to encourage employees and employers to use ridesharing programs as a means of alleviating traffic congestion and reducing air pollution.

COMMENTS

The exemption provided by this program originally was established by Chapter 25, Statutes of 1982 (AB 548, Ryan), and was allowed for income years 1981 through 1985. Chapter 1444, Statutes of 1986 (SB 1794, Beverly), which extended the exemption through 1990, was repealed in 1987. The current program was enacted by Chapter 1437, Statutes of 1988 (SB 1904, Morgan).

Exclusion/Exemption:

EMPLOYEE CHILD AND DEPENDENT CARE BENEFITS

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Section 17131, which partially conforms to Internal Revenue Code Section 129.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**PIT**
1996-97	$28
1997-98	31
1998-99	34

DESCRIPTION

This program allows taxpayers to exclude from their gross income the compensation or other benefits they receive from an employer for qualified child and dependent care services. In addition to exempting these employer-provided benefits, an employee may exempt the amount of child and dependent care benefits received through a salary-reduction agreement entered into with an employer. In this case, the employee elects to receive a salary reduction in the amount of the additional employer-paid child or dependent care benefits.

RATIONALE

This program provides tax relief for employees who receive child and dependent care benefits through either of the methods above, and an incentive for employers to make such benefits a part of their employees' overall compensation package. The program's underlying rationale is that it benefits society as a whole in several ways. One of these ways, proponents argue, is through increased labor output and productivity, which occurs because the availability of child care enables more individuals to work and reduces employee absenteeism and turnover. Another cited benefit of the program is a reduction in the need for government-provided child care programs.

COMMENTS

This program covers payments or services provided by the employer for child or dependent care services, which enable or assist the taxpayer to work. To qualify for the program, the assistance must be provided under a plan that does not discriminate in favor of officers, owners, or higher-paid employees, and which meets various other requirements.

Federal tax law, to which California conforms, limits the exclusion for employee child care benefits (both those paid by the employer and those provided through employee salary reductions) to $5,000 per year ($2,500 in the case of married individuals who file tax returns separately from their spouse), beginning in 1987. Individuals are allowed to use this income exclusion in conjunction with the tax credit for child and dependent care expenses.

Exclusion/Exemption:

TAX-EXEMPT STATUS FOR QUALIFYING CORPORATIONS

Program Characteristics	
Tax Type:	*Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 23701 through 23710.*

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	***BCT***
1996-97	*$92*
1997-98	*97*
1998-99	*99*

DESCRIPTION

This program allows an exemption from the BCT franchise and income taxes for the income of qualifying tax-exempt nonprofit and charitable organizations. (The BCT *franchise* tax is levied against all banks and corporations doing business in the state. In contrast, the BCT *income* tax is imposed on banks and corporations that do not do business in the state, but which have income from California sources, such as holding companies and firms engaged only in interstate commerce.)

This exemption extends to the minimum franchise tax imposed on corporations which otherwise would have a tax liability less than that amount. Qualifying organizations are still subject to taxes on "unrelated business income," which includes income associated with activities that are not directly related to their tax-exempt status. For example, a church would have to pay taxes on the income earned from the lease of its personal property to a business, even though its income from religious-related activities would be tax exempt.

RATIONALE

This program provides tax relief to organizations which are engaged in various charitable, or otherwise not-for-profit, activities. The tax-exempt status generally applies to nonprofit religious, charitable, educational, and scientific organizations. Certain homeownership organizations, civic and business organizations, and financial cooperatives also qualify for tax-exempt status. The commonly cited rationale for exempting such organizations from taxation is that they provide social benefits which are worthy of indirect public financial support.

Exclusion/Exemption:

RECYCLED OR REDEEMED BEVERAGE CONTAINER REDEMPTION PAYMENTS

Program Characteristics	
Tax Type:	Personal Income Tax (PIT). Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 17153.5 and 24315.

Estimated Revenue Reduction		
(In Millions)		
Fiscal Year	**PIT**	**BCT**
1996-97	NA	NA
1997-98	NA	NA
1998-99	NA	NA

DESCRIPTION

This program allows taxpayers to exclude from gross income the amounts they receive for returning recyclable beverage containers to state-designated recycling centers.

RATIONALE

This program provides an incentive for taxpayers to return beverage containers to recycling centers. The program's underlying rationale is that resource conservation and litter reduction are worthy of public financial support.

COMMENTS

This program was enacted by Chapter 1290, Statutes of 1986 (AB 2020, Margolin), which established a statewide recycling program for certain types of beverage containers. The program's exclusion covers the amounts that a taxpayer receives as a refund/redemption value. The term "refund value" refers to the minimum refundable value established by the California Department of Conservation (DOC) for each type of beverage container. Generally, the current refund value is 2.5 cents per container.

Exclusion/Exemption:

BENEFITS PROVIDED UNDER CAFETERIA PLANS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Section 17131, which generally conforms to Internal Revenue Code Section 125.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	***PIT***
1996-97	*$170*
1997-98	*195*
1998-99	*220*

DESCRIPTION

This program allows employees to exclude from their gross income benefits received from cafeteria plans. Such cafeteria plans are employer-sponsored benefit packages that offer employees a choice between taking monetary compensation or qualified benefits. The employee is allowed to choose among the "qualified benefits" that a particular employer's plan offers, which can include such benefits as accident and health coverage, group-term life insurance coverage, or child and dependent care benefits. Qualified benefits cannot include deferred compensation plans, except for certain plans maintained by educational institutions. If the employee chooses to take monetary compensation instead of the qualified benefits, the monetary compensation must be included in gross income subject to taxation.

RATIONALE

This program creates an incentive for employers to provide, and employees to accept, contributions made to benefit plans in lieu of monetary compensation. This is because a given contribution amount to such a program is worth more to employees on an after-tax basis than an equivalent amount of taxable income. In addition, the program provides both employers and employees with an incentive to make these types of benefits a standard part of the employees' compensation package. The rationale advanced for the program is that it furthers a desirable social goal, because it improves workers' income security and reduces the need for governments to provide these benefit programs themselves.

COMMENTS

California has been largely in conformity with federal law regarding cafeteria plan benefits since 1987.

Exclusion/Exemption:

WATER'S-EDGE ELECTION

Program Characteristics	
Tax Type:	Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 25110 through 25112.

Estimated Revenue Reduction

(In Millions)

Fiscal Year	BCT
1996-97	$335
1997-98	340
1998-99	355

DESCRIPTION

This program gives a unitary multinational corporation the option of computing its California taxable income on a "water's-edge" basis, which means the company's tax liability is determined on the basis of its United States income only, instead of on the basis of its worldwide income. (That is, nondomestic income may be excluded for tax-computation purposes.)

A qualifying water's-edge corporation is also allowed to deduct a percentage of its foreign dividends. Corporations electing to file on a water's-edge basis must do so for a seven-year period following the year of election.

RATIONALE

This program provides tax relief to multinational corporations by allowing them to compute their taxes using an alternative method. The net effect is that they are allowed to exclude the activities of foreign operations for the purposes of calculating California tax liabilities under BCT. One rationale for the program is that it is burdensome for some multinationals to keep track of all their worldwide income sources and amounts for the sole purpose of computing California's tax liability. The water's-edge election provides these corporations with an alternative that makes it easier and less costly for them to comply with California's tax laws, because it relies on the same information now required for federal tax purposes.

It also is argued by proponents that the worldwide method could result in an unfairly high allocation of income for California tax purposes, and that the water's-edge method reduces this distortion.

DISTRIBUTION OF BENEFITS

As shown in Figure 1, the benefits of the water's-edge election are claimed by a broad

Figure 1

Water's-Edge Election Tax Benefits by Receipt

1998 Income Year

	Percent of	
Total Receipts (In Millions)	Total Taxpayers Benefitting	Total Amount Claimed
Under $1	13.3%	0.1%
1–10	26.7	0.1
10–50	25.3	0.1
50–100	6.0	0.5
100–500	16.5	4.2
500–1,000	5.1	7.8
Over 1,000	7.2	87.4

spectrum of businesses, based on total receipts. However, total benefits accrue disproportionately to larger corporations. This is due to the fact that corporations with worldwide operations who can benefit from a water's-edge election tend to be large entities. Figure 2 indicates that the total benefits associated with the program accrue largely to manufacturing and to finance, real estate, and insurance enterprises.

COMMENTS

This program was enacted by Chapter 660, Statutes of 1986 (SB 85, Alquist), and is applicable for tax years beginning in 1988.

Figure 2

Water's-Edge Election Tax Benefits by Industry

1998 Income Year

	Percent of		
Industry Type	**Gross State Product**	**Total Taxpayers Benefitting**	**Total Amount Claimed**
Agriculture, Forestry & Fishery	3.0%	0.9%	0.1%
Construction	3.8	0.8	0.1
Manufacturing	15.9	20.6	50.9
Services	25.1	13.1	0.2
Trade	18.2	45.1	1.1
Finance, Real Estate & Insurance	25.9	17.0	30.7
Utilities & Transportation	8.2	2.5	17.1

Exclusion/Exemption:

LIMITED PARTNERSHIP INVESTMENT SOURCE RULES

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Section 17955.*

Estimated Revenue Reduction (In Millions)	
Fiscal Year	***PIT***
1996-97	*$10*
1997-98	*10*
1998-99	*10*

DESCRIPTION

This program exempts from taxation dividends, interest, or gains and losses from qualifying investment securities of limited partnership members who reside outside of California, and whose only contact with this state is through a broker, dealer, or investment advisor located in the state. "Qualified investment securities" include, but are not limited to, common stock, bonds, and mortgage-based or asset-backed securities.

RATIONALE

This program provides tax relief to members of limited partnerships residing outside of California that make use of investment services within the state, on the grounds that such activity does not constitute "doing business" in the state.

COMMENTS

Prior to this program, members of limited partnerships were subject to taxation on investment income because they were deemed to be "doing business" within the state, even though they did not physically reside in California. This increased the cost of using investment services in California, placing this industry at a comparative disadvantage in California relative to other states such as New York and Massachusetts, which had rules exempting limited partnership investment source-income from taxation.

Exclusion/Exemption:

CREDIT UNION TREATMENT

Program Characteristics	
Tax Type:	Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Section 23153.

Estimated Revenue Reduction
(In Millions)

Fiscal Year	BCT
1996-97	$13
1997-98	13
1998-99	13

DESCRIPTION

This program exempts credit unions and nonprofit cooperative associations from the state minimum franchise tax. This is the amount that a corporation must pay, regardless of income. It is currently $800 for most corporations, although new, small corporations pay a lower minimum franchise tax.

RATIONALE

This program provides tax relief to credit unions and nonprofit cooperative associations, based on the rationale that the primary goal of these organizations is to provide low-cost financial services to members who might not otherwise have access to such services.

COMMENTS

While credit unions and nonprofit cooperative associations are exempt from any minimum franchise tax, credit unions must prepay a tax of $25 when they incorporate under the laws of California, or when they qualify to transact business in California.

Exclusion/Exemption:

SMALL BUSINESS ALTERNATIVE MINIMUM TAX

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).* *Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17062,17309, 23036, 23453, 23455 through 23457, and 23459, which generally conform to Internal Revenue Code Sections 55 through 59.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT	BCT
1996-97	NA	NA
1997-98	NA	NA
1998-99	NA	NA

DESCRIPTION

For certain businesses and individuals which have large amounts of deductions, credits, exemptions, and exclusions, the Alternative Minimum Tax (AMT) may limit the amount of these "tax preference" items that may be claimed, or may impose an additional tax or limit tax credits receivable to ensure that these taxpayers are not receiving more than a "reasonable" amount of benefits from these preference items. This program exempts certain small businesses from the state AMT.

To qualify for this treatment, the taxpayer must (1) own or have ownership interest in a trade or business, and (2) have aggregate adjusted gross receipts of less than $1 million from these trades or businesses. Proportionate interest in a partnership, regulated investment company, real estate investment trust, and real estate mortgage investment conduit are includable in the gross receipt totals.

RATIONALE

This program provides tax relief to qualified small businesses, thereby increasing their economic viability. The rationale is based on the belief that encouraging the development of small business helps the vitality of state and local economies.

Exclusion/Exemption:

TUITION REDUCTION OR WAIVER

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Section 17131, which conforms to Internal Revenue Code Section 117(d).

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**PIT**
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program allows an exclusion from gross income for tuition reductions or waivers received by an employee of a qualified educational institution for undergraduate education provided to the employee, the employee's spouse, or dependent children. It also provides tuition reductions or waivers for graduate education of the employee, who must be engaged in teaching or research activities for the qualifying educational institution.

The educational institution may provide the tax-exempt tuition reduction or waiver only if it does not discriminate in favor of highly compensated employees. A qualified educational institution must maintain a regular faculty and curriculum, and have a regularly enrolled student body in attendance at the institution.

RATIONALE

This program provides tax relief to university and college employees based on the rationale that individuals in these occupations should be provided additional public support for their activities and because of the perceived importance of education. Schools have argued for the exemption as an added benefit to attract and maintain highly sought-after employees, who otherwise might be hired at other universities or by private sector companies. (This reasoning, however, does not provide a rationale for *public* financial support of this program.)

COMMENTS

On several occasions in the late 1970s and early 1980s, the Internal Revenue Service (IRS) and some Members of Congress attempted to review or repeal this program, but met with strong resistance. As a method of curbing its use, the federal government restricted the use of the tax-exempt tuition reduction to undergraduate education only, except in the case of an employee who is concurrently attending graduate school.

Due to rising costs in recent years, some universities have limited the amount of tuition reduction to new employees as a means of cutting costs; however, many still provide a full tuition waiver.

Exclusion/Exemption:

SCHOLARSHARE TRUST INCOME

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Sections 17140, 23735, 24306, and 24328.*

Estimated Revenue Reduction *(In Millions)*	
Fiscal Year	***PIT***
1996-97	*—*
1997-98	*Minor*
1998-99	*$1*

DESCRIPTION

The Golden State Scholarshare Trust program was established by the state to encourage families to save for the post-secondary education expenses of their children. Contributions under a Scholarshare Trust Account are not included for state tax purposes in gross income. Earnings on contributions under the Scholarshare Trust Account are not taxable when earned, but rather included in the beneficiaries' gross income upon distribution for educational purposes.

Contributions to and earnings on the trust must be used for qualified higher education expenses at a public or private post-secondary institution, including the following: tuition, fees, books, supplies, and (in most cases) room and board. Maximum contributions to the Scholarshare Trust Account are limited to estimated qualified expenses that can be incurred for a designated beneficiary to obtain a baccalaureate degree at an institution of higher education in California within four years.

RATIONALE

This program is one of several incorporated into state law that makes it financially easier for families to afford to send their children to colleges, universities, or other post-secondary educational institutions. The underlying rationale is that higher education is worthy of public financial support.

COMMENTS

While the major thrust of this program is to make it easier for households to pay for post-secondary education, there are broader issues associated with this program. In particular, if there exist *social* benefits to post-secondary education in addition to *private* benefits, a less-than-optimal amount of education may result in the absence of programs like this. Since the after-tax price of post-secondary education is lowered through this program, it would typically be expected to result in an increase in the amount of education undertaken.

Some argue that sufficient public support for higher education already occurs and that programs such as this may actually stimulate consumption in excess of the appropriate amount.

Exclusion/Exemption:

CAPITAL GAINS ON SMALL BUSINESS STOCK

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Section 18152.5, which partially conforms to Internal Revenue Code Section 1202.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT
1996-97	—
1997-98	—
1998-99	$15

DESCRIPTION

This program provides a PIT exclusion for 50 percent of the gain from the sale or exchange of qualified small business stock that is held for more than five years. The amount of the exclusion may not exceed the greater of the following (for a married couple filing a joint return) (1) $10 million, or (2) ten times the amount of the qualified small business stock under specified conditions. These amounts are halved for single taxpayers. The stock must be issued by a C corporation between January 1, 1993 and January 1, 1999 in order to qualify for the exclusion.

Qualified stock must be issued by a corporation with less than $50 million in total gross assets (before and after the stock issuance), and 80 percent of its total dollar payroll must be attributable to employment in California. "Qualified businesses" are those where at least 80 percent of the business assets are used to conduct qualified business or trade activities. Qualified business, in general, does not include professional or financial services or the hospitality industry. The measure was designed primarily to promote startup operations in manufacturing and related activities.

RATIONALE

The program was conceived of as a means by which small businesses in particular industries could gain access to the capital markets more easily than they otherwise would. Small, new or expanding businesses may face more substantial hurdles in raising funds for growth than large business entities. This program represents an effort to reduce the costs of access to required financial capital.

COMMENTS

The federal government also has a PIT exclusion for 50 percent of small business stock gains held for five years or more. The design of the state's provision was largely based on the federal law but does not incorporate certain of its provisions including the rollover of capital gains.

The small business stock exclusion, which results in a reduction in capital costs, represents an attempt to address what are perceived as multiple issues relating to small businesses. These issues may stem from market failure of some type, but may also relate to the achievement of other social goals. For example, some argue that small businesses and industries face a capital shortage; that, for some reason, insufficient funds are being channeled to small businesses. This may be due to insufficient or inaccurate information, or an aversion to perceived high-risk ventures. Some feel that by increasing the return to investors, additional capital can be channeled into the small business sector.

Other proponents suggest that the cost of capital itself is the problem, and that a subsidy is necessary for small business start-ups and expansions to be viable. Finally, some supporters take the view that small businesses are worthy of special support, perhaps because they may be more labor intensive than larger businesses, or because small businesses tend to be a substantial source of product development and innovation.

Economists differ, and empirical evidence is inconclusive, regarding the validity of some of the claims regarding the positive aspects of small business activities or the existence of capital shortage for this sector. Even if the justifications given for the program are accurate, there may exist alternative ways to assist small business enterprise.

Adjustment:

CONTRIBUTIONS TO INDIVIDUAL RETIREMENT ACCOUNTS

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Sections 17085, 17201, 17203, 17210.6, 17501, 17504 through 17509, 17551, and 17554, which largely conform to Internal Revenue Code Sections 219 and 408.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**PIT**
1996-97	$51
1997-98	57
1998-99	62

DESCRIPTION

This program allows a deduction when computing adjusted gross income (AGI) for contributions to a taxpayer's Individual Retirement Account (IRA). The annual maximum deduction permitted is the lesser of $2,000 or 100 percent of the individual's compensation. A nonworking spouse may make a deductible IRA contribution of up to $2,000. The maximum aggregate contribution for a married couple is the lesser of $4,000 or 100 percent of their combined compensation.

If a taxpayer is a participant in an employer-sponsored retirement plan, the above deduction limitation is gradually reduced and then eliminated at a certain point. For the 1998 tax year, taxpayers who belong to employer-established pension programs can claim the full deduction, provided their AGI is below $30,000 for single filers, and $50,000 for married joint-return filers. For incomes above these amounts, the deduction is gradually phased-out, and then eliminated altogether for taxpayers whose AGI exceeds $40,000 for single filers and $60,000 for married joint-return filers.

RATIONALE

This program provides an incentive for taxpayers to save for retirement. It does this by permitting taxpayers to defer taxes on IRA contributions until they are withdrawn (after age 59½), thereby increasing the investment earnings on such monies.

In addition, the program provides tax relief to IRA account owners, to the extent that their marginal income tax rates are lower when they retire compared to when they are working.

COMMENTS

California has generally been in conformity with federal law regarding deductions for IRA account contributions since 1987. The state incorporated changes made at the federal level for tax years beginning in 1996 regarding maximum deductible contributions.

Adjustment:

CONTRIBUTIONS TO SELF-EMPLOYED RETIREMENT PLANS

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Sections 17501, 17504, 17506, and 17507, which generally conform to Internal Revenue Code Sections 219, 401 through 404, 408, and 415.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**PIT**
1996-97	$145
1997-98	155
1998-99	170

DESCRIPTION

This program allows a deduction when computing adjusted gross income (AGI) for a taxpayer's contributions to a self-employed retirement plan (these plans are usually referred to as "Keogh" plans).

For defined contribution plans, the deduction is limited to the lesser of $30,000 or 25 percent of earned income. For defined benefit plans, the annual normal retirement benefit limitation is the lesser of $90,000 or 100 percent of average compensation for the highest three consecutive years of active plan participation. The $90,000 limitation is adjusted annually based on the cost of living; for 1998, this adjusted figure was $130,000. California law requires that amounts used as earned income for federal income tax purposes must also be used for state income tax calculations.

RATIONALE

This program provides self-employed individuals an incentive to save for retirement, by granting them the same basic type of tax deferral that is available to individuals who are covered by employer-established retirement programs.

DISTRIBUTION OF BENEFITS

The accompanying table indicates that taxpayers receiving benefits from this program are broadly distributed across the income spectrum. However, the majority of benefits accrue to those in the upper-income categories, with almost 80 percent of amounts claimed by taxpayers earning more than $100,000. Average benefits also increase as income increases throughout most of the income spectrum.

Contributions to Self-Employed Retirement Plans Adjustment

1998 Tax Year

Adjusted Gross Income ($000)	Percent of: Total Taxpayers Benefitting	Percent of: Total Amount Claimed	Average Amount Claimed
$0-20	1.6%	0.1%	NA
20-40	6.3	1.2	$167
40-60	11.0	4.1	333
60-80	14.1	8.1	519
80-100	11.5	7.5	591
100-150	19.9	18.5	842
150-200	11.0	16.2	1,333
200-250	6.3	12.1	1,750
250-500	12.6	23.1	1,667
Over 500	5.8	9.3	1,455

COMMENTS

In general, no distinction is made between (1) pension, profit-sharing, and other retirement plans, including simplified employee pension plans established by corporations; and (2) plans established by self-employed individuals and partnerships. In addition, contributions and deductions for a self-employed participant in a qualified plan are limited in the same way as those of an employee participant. California has been largely in conformity with federal law in this area since 1987.

Adjustment:

CONTRIBUTIONS TO EDUCATION INDIVIDUAL RETIREMENT ACCOUNTS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Sections 17085, 17201, 17210.6, 17501, and 17505 through 17509, which generally conform to Internal Revenue Code Sections 219 and 408.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT
1996-97	—
1997-98	$1
1998-99	7

DESCRIPTION

This program allows for an exclusion from gross income when computing adjusted gross income (AGI) for earnings on contributions to an Individual Retirement Account (IRA) established for the purpose of funding a child's post-secondary educational expenses. Under the program, up to $500 per child, per year may be contributed to an educational IRA, effective for tax years beginning after 1997. Earnings on contributions are distributed tax-free provided that they are used for the purposes of the child's qualified post-secondary education expenses.

Qualified expenses include tuition, fees, books, supplies, equipment, and (in most cases) room and board. The program is available for taxpayers with modified AGI of up to $150,000 (joint returns) and $95,000 (single taxpayers). The program is phased out for filers with modified AGI between $150,000 and $160,000 (joint returns) and $95,000 and $110,000 (single taxpayers).

RATIONALE

This program provides favorable tax treatment of investment earnings specifically set aside for a child's post-secondary education. Although contributions to the education IRA themselves are not deductible from income, the incentive to earmark savings for educational purposes involves recognition of the high costs of education and the necessity of post-secondary education for many careers. Proponents argue that encouraging such behavior is deserving of public support.

COMMENTS

California generally conforms to federal tax law with regard to education IRAs.

Adjustment:

MEDICAL SAVINGS ACCOUNTS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).* *Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17201, 17215, and 24343.3, which generally conform to Internal Revenue Code Sections 106, 138, and 220.*

Estimated Revenue Reduction (In Millions)		
Fiscal Year	***PIT***	***BCT***
1996-97	*$4*	*NA*
1997-98	*8*	*NA*
1998-99	*10*	*NA*

DESCRIPTION

This program allows small business employers and self-employed individuals to create tax-favored Medical Savings Accounts. In general, employer or employee contributions are limited to 65 percent of the annual health insurance deductible for taxpayers with individual insurance coverage. The comparable limitation for taxpayers with family coverage is 75 percent.

Employer contributions are excluded, and employee contributions deductible, from the employee's income for tax purposes. Any earnings accumulated in the Medical Savings Account are tax-free. Contributions and earnings placed in this account may be withdrawn for medical purposes without penalty. Withdrawals made for other purposes may be subject to tax, as well as a penalty, under certain circumstances.

RATIONALE

This program provides an incentive for taxpayers to save for medical treatment and emergencies. It does this by permitting taxpayers to defer taxes on their Medical Savings Account contributions and for employers, to deduct contributions made to employee accounts.

COMMENTS

This program provides a "double" tax incentive. First, it lowers the adjusted gross income of taxpayers by exempting from income all of the *contributions* they make towards their Medical Savings Account. Second, it does not tax *earnings* accumulated or *withdrawals* made for medical purposes.

Adjustment:
MOVING EXPENSES

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Sections 17072, 17076, 17084, 17134.5, 17201, and 17218, which conform to Internal Revenue Code Sections 62, 67, 82, 132, and 217.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	*PIT*
1996-97	*$20*
1997-98	*20*
1998-99	*20*

DESCRIPTION

This program allows taxpayers an above-the-line deduction when computing their adjusted gross income (AGI) for the qualified moving expenses they incur, associated with beginning a new job in a new location. Only those expenses that are not paid or reimbursed by the employer are deductible. The allowable expenses taken as a deduction in calculating AGI are those direct expenses associated with relocation, but specifically excluding: (1) meals consumed while traveling and living in temporary quarters near the location of new employment; (2) preliminary house-hunting travel prior to the move; (3) temporary living expenses for up to 30 days in the general location of new employment; and (4) lease expenses associated with the new or old residence.

In order for the taxpayer to claim the deduction, the move must meet two basic tests—a distance test and a time test. The *distance* test requires that the taxpayer's new employment must be at least 50 miles further from the taxpayer's old residence than the former place of employment was from the taxpayer's old residence. The *time* test requires that the taxpayer be employed on a full-time basis at the new location for at least 39 weeks during the 12-month period following the move. Self-employed individuals must work in the new location for at least 78 weeks during the two years following the move in order to claim the deduction.

RATIONALE

This program provides tax relief to individuals whose employment requires that they relocate. The basic rationale is that such moving expenses actually are a type of employee business expense that is necessary in order to earn income, and that employees often have little control over incurring such expenses.

Adjustment:
HEALTH INSURANCE PREMIUMS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Sections 17201, 17270, and 17273, which partially conform to Internal Revenue Code Section 162.*

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	***PIT***
1996-97	*$34*
1997-98	*46*
1998-99	*50*

DESCRIPTION

Under this program, self-employed taxpayers are allowed to deduct a percentage of the costs they incur for health insurance premiums for themselves and their families, not to exceed the taxpayer's earned income from his/her trade or business. California law allows self-employed taxpayers to deduct 40 percent of their costs for health insurance premiums. This deduction may be taken regardless of whether the taxpayer itemizes deductions.

RATIONALE

The purpose of this program is to encourage taxpayers to provide health insurance for themselves and their families. The program's rationale reflects the view that self-employed individuals incur these business-related expenses which can be treated in the same fashion as business-related expenses incurred by larger corporations.

COMMENTS

Federal tax law increased the deductible percentage for health insurance premiums from 25 percent to 30 percent for tax years beginning after 1994. The percentage deduction for federal purposes increases to 40 percent for the 1997 tax year and then increases further at fairly regular intervals thereafter until the deductible percentage reaches 100 percent for tax years beginning after 2006.

For tax year 1997, the California deductible percentage was 40 percent, with the amount scheduled to decline to 25 percent for subsequent tax years. However, under Chapter 322, Statutes of 1998 (AB 2797, Cardoza) and Chapter 323, Statutes of 1998 (AB 2798, Machado), the 40 percent deductibility is scheduled to continue.

Adjustment:

EMPLOYEE CONTRIBUTIONS TO QUALIFIED RETIREMENT AND SALARY REDUCTION PLANS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Section 17501, which conforms to Internal Revenue Code Sections 401 through 404a, 408, and 457.*

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	***PIT***
1996-97	—
1997-98	—
1998-99	—

DESCRIPTION

This program allows an exclusion from gross income for a taxpayer's contributions to a qualified employer-sponsored retirement plan, a simplified employee pension plan (SEP), or a cash or defined-arrangement plan (CODA) such as a 401(k), 403(b), or 457 plan. Taxpayer contributions to a CODA are limited annually and vary by type of plan.

RATIONALE

This program provides individuals with an incentive to participate in employer-sponsored retirement plans and salary reduction plans, by permitting them to defer taxes on their contributions until they are "withdrawn" as benefits after retirement. This deferral reduces the cost of funding a specified level of retirement benefits, because the present value of taxes paid upon the withdrawal of benefits is less than the present value of the taxes that would be paid when the contributions are made, due to such factors as inflation. In addition, the program provides a further tax reduction to such individuals to the extent that their marginal income tax rates are lower when they retire and receive retirement distributions compared to when they made the contributions.

COMMENTS

The revenue effects of this program are included in those for the program "Employer Contributions to Pension Plans." California has generally been in conformity with federal law since 1987. See comments under "Employer Contributions to Pension Plans."

Deduction:

STANDARD DEDUCTION

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Sections 17041, 17073, and 17073.5.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	*PIT*
1996-97	*$840*
1997-98	*910*
1998-99	*950*

DESCRIPTION

This program allows taxpayers who do not itemize their income tax deductions to claim a standard deduction. The deduction amount for the 1998 income year was $2,642 for single-return taxpayers and $5,284 for joint-return taxpayers. The standard deduction is indexed annually for inflation, as measured by the percent change in the California Consumer Price Index for June of the tax year compared to June of the preceding year.

RATIONALE

This program is intended to simplify state tax administration and the tax-computation process for taxpayers who have less than a specified level of itemized tax deductions.

DISTRIBUTION OF BENEFITS

As shown in the accompanying table, the standard deduction is a program which is used heavily by lower-to-moderate income taxpayers. Almost 75 percent of the taxpayers claiming the standard deduction have $40,000 or less in annual income, and over three-quarters of all deductions go to taxpayers earning $60,000 or less annually. For the lowest income class, the great majority of benefits (in excess of 90 percent) go to single taxpayers or married taxpayers filing separately. Average claims for this deduction decline in the higher income categories due to the increased prevalence of the use of itemized deductions.

Standard Deduction

1998 Tax Year

Adjusted Gross Income ($000)	Percent of		Average Amount Claimed
	Total Taxpayers Benefitting	Total Amount Claimed	
$0-20	39.6%	13.8%	$57
20-40	33.9	35.8	174
40-60	15.9	28.3	294
60-80	5.5	12.2	367
80-100	2.1	4.7	364
100-150	1.6	3.3	341
150-200	0.5	0.8	280
200-250	0.2	0.4	308
250-500	0.5	0.7	240
Over 500	0.3	0.2	143

COMMENTS

Considerable disagreement exists regarding how the tax expenditure associated with the standard deduction should be defined and measured. The revenue reduction amounts shown above represent the amounts the state would gain if the standard deduction were eliminated altogether, and those taxpayers who would otherwise claim it were instead

left with itemizing their deductions. Thus, for a single taxpayer with itemizable deductions of $1,000, the revenue reduction for this program would be based on an increased deduction of $1,642 (reflecting the excess of the standard deduction over the taxpayer's itemizable deductions).

However, alternative ways of defining and computing the tax expenditure amount have been suggested which can lead to significantly different revenue effects. For example:

- One view is that the standard deduction is part of the "basic tax structure" because it is available to all taxpayers. In this view, the standard deduction does *not* give rise to any tax expenditure, and only those itemized deductions in *excess* of the standard deduction are tax expenditures.
- Another view is that the standard deduction is a tax expenditure which is claimed, either directly or indirectly, by *all* taxpayers. This view is based on the notion that it is not possible to distinguish between itemized deductions, which *are* tax expenditures, and the standard deduction, which is really a "proxy" for some minimal level of itemized deductions. Under this view, the cost of this program should reflect not only the standard deductions explicitly claimed by nonitemizers, but also the standard deductions which itemizers implicitly receive from the "zero bracket amount" that is built into the state's tax rate schedules. In other words, this view holds that, to identify the full cost of this tax expenditure program, one must add together (1) the standard deductions claimed by nonitemizers, and (2) that portion of the itemized deductions claimed by itemizers which is equivalent to the standard deduction.

Deduction:

CASUALTY LOSSES

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).* *Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17131, 17207, and 24347.5 which largely conform to Internal Revenue Code Section 165.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT	BCT
1996-97	$15	$1
1997-98	20	1
1998-99	20	1

DESCRIPTION

This program allows as a deduction from gross income any qualifying casualty losses that exceed 10 percent of federal adjusted gross income (AGI), to the extent that these losses are not compensated for by insurance or other means. In addition, the program allows that subgroup of casualty losses associated with certain officially designated disasters (as proclaimed by the President or the Governor) to be (1) carried back as a deduction against income for the prior year, and/or (2) carried forward as a deduction against future income for up to five years. Fifty percent of the amount of any such loss remaining after five years may be carried forward for the next ten taxable years.

The term "casualty loss" includes losses arising from fire, storm, shipwreck, floods, and other such casualties, or from theft. Each separate casualty or theft loss is deductible only to the extent that it exceeds $100, and the total of all individual losses is deductible only to the extent that it exceeds 10 percent of federal AGI.

California law incorporates federal law allowing a deduction for corporate losses sustained and not compensated by insurance proceeds or other means. The corporate provisions regarding the deduction and carryover of disaster losses are the same as the provisions under the PIT.

RATIONALE

This program provides tax relief to those individuals, businesses, and corporate entities which suffer large casualty losses, have a tax liability, and (in the case of PIT) are able to itemize deductions. The most commonly cited rationale for the program is that it helps to relieve the hardships that these losses can impose on such individuals and firms.

COMMENTS

This program has a number of important side effects and tax-equity considerations. First, because the program shifts part of the cost of a taxpayer's property losses to the general taxpayer, it serves as a form of indirect property insurance. As such, it reduces the costs of not having insurance and gives taxpayers an incentive to purchase less private insurance than they otherwise might. Insurance can result in a phenomenon known as "moral hazard," whereby an insured individual behaves in a manner which results in increased risk since the full costs of such behavior are not directly borne by the taxpayer. Private insurers attempt to control these tendencies by instituting experience-adjusted insurance

premiums and deductibles. This tax program can be perceived as a supplemental insurance policy, but without such protective devices.

Second, depending on the size of a casualty loss and a taxpayer's income level, different taxpayers sustaining identical casualty losses can be provided different amounts of tax relief, due to such factors as the 10 percent threshold, the $100 minimum-loss requirement, and differences in marginal income tax rates. For example, a high-income taxpayer may not be able to claim any deduction for a $5,000 casualty loss due to the 10 percent threshold, whereas a low-income taxpayer would qualify for a large deduction. Conversely, the dollar amount of tax relief provided for a given dollar amount of casualty loss in excess of the 10 percent threshold will be greater for a higher-income taxpayer than for a lower-income taxpayer, due to the difference in their marginal tax rates.

The estimated revenue amounts shown above are for revenue reductions associated only with the deduction for casualty losses. The revenue reduction estimates for disaster-related losses depend on the type and scope of the disaster, and reflect larger carryback/carryforward deduction allowances.

Deduction:
MEDICAL AND DENTAL EXPENSES

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Section 17201, which conforms to Internal Revenue Code Section 213.

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	**PIT**
1996-97	$110
1997-98	115
1998-99	120

DESCRIPTION

This program allows taxpayers to claim a deduction for specified medical and dental expenses related to treatment of the taxpayer, spouse, and dependents, to the extent that these expenses exceed 7.5 percent of federal adjusted gross income (AGI) and are not compensated for by insurance or other means.

Qualifying medical expenses include payments for diagnosis, cure, mitigation, treatment, or prevention of disease, including certain related travel costs and lodging expenses. They also include the costs of prescription drugs, plus nonprescription insulin. For tax years after 1996, the definition of medical care was expanded to include qualified long-term care and long-term care insurance premiums.

RATIONALE

This program provides tax relief to individuals who incur nonreimbursed medical expenses. The rationale for the program is that such expenses can impose extraordinary and involuntary financial burdens. In addition, the program provides some incentive for taxpayers to seek proper medical attention and preventive medical care, thereby improving the overall level of public health.

DISTRIBUTION OF BENEFITS

As shown in the accompanying table, the number of taxpayers benefitting from medical and dental expense deductions is broadly distributed, but concentrated in the lower and moderate income categories. Total dollar deductions are also concentrated in the lower-to-middle income categories, with over 40 percent of the total deductions going to those taxpayers earning $60,000 annually or

Medical and Dental Expense Deduction

1998 Tax Year

Adjusted Gross Income ($000)	Percent of Total Taxpayers Benefitting	Percent of Total Amount Claimed	Average Amount Claimed
$0-20	12.2%	2.5%	$51
20-40	33.3	16.8	124
40-60	25.6	21.0	202
60-80	15.3	17.7	284
80-100	6.0	12.6	517
100-150	5.4	14.3	654
150-200	1.2	7.6	1,500
200-250	0.4	2.5	1,500
250-500	0.6	4.2	1,667
Over 500	0.1	0.8	NA

less. The average benefit from the program increases with income except in the highest income group.

COMMENTS

Although the basic rationale for this program relates to the involuntary nature of many medical expenses, the deduction itself can be claimed for a variety of expenses that do not necessarily fall into this category. Such expenses include those for rest cures, and other basically "optional" expenses, many of which are not covered under medical insurance programs because insurers consider them to be discretionary.

This program gives rise to a number of economic side effects and tax-equity considerations. For example, because the program essentially shifts certain health-related expenses to the general taxpayer, it provides a form of indirect health insurance to individuals. Thus, it can give individuals an incentive to purchase less private health insurance than they otherwise might.

The tax subsidy given for a dollar of medical expenses also can differ under the program, depending on such factors as a taxpayer's income level and amount of total medical expenses. For instance, the tax subsidy for low dollar amounts of medical expenses can be greatest for certain low-income taxpayers, since the 7.5 percent threshold can disqualify higher-income taxpayers from claiming them. On the other hand, the tax subsidy for high dollar amounts of medical expenses can be greatest for higher-income taxpayers, due to their higher marginal income tax rates.

Deduction:
CERTAIN TAXES PAID

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Sections 17201, 17220, and 17222, which partially conform to Internal Revenue Code Section 164.*

Estimated Revenue Reduction
(In Millions)

Fiscal Year	PIT
1996-97	$658
1997-98	671
1998-99	706

DESCRIPTION

This program allows taxpayers to claim an itemized deduction for the amount of certain property taxes, vehicle taxes, and other taxes paid to the state and its local governments. Specifically, the program allows a deduction for: (1) state, local, and foreign real property taxes; (2) state and local personal property taxes (including only the portion of the state vehicle license fee that does not represent annual charges for vehicle registration and vehicle weight); (3) one-half of self-employment taxes; and (4) other state, local, and foreign taxes relating to a trade or business, or to a property held for the production of income. Generally, California law is the same as federal law except that California specifically prohibits the deduction of state, local, and foreign income, war profits, and excess profits taxes.

RATIONALE

This program provides tax relief under the rationale that already-paid taxes reduce the amount of a taxpayer's net income, thereby reducing the taxpayer's ability to pay state income taxes. The program also has been justified on the grounds that income should not be subject to double taxation by California state and local governments.

DISTRIBUTION OF BENEFITS

The largest portion of taxes which is deductible under PIT is the local property tax. The income distribution of the deductibility of property taxes is shown in the accompanying table. The program largely benefits middle-income taxpayers, both in terms of the of number of taxpayers benefitting, as well as the distribution of total deductions. Average benefits increase along with income due to the high correlation between income and home values.

Real Property Taxes Deduction
1998 Tax Year

Adjusted Gross Income ($000)	Percent of Total Taxpayers Benefitting	Percent of Total Amount Claimed	Average Amount Claimed
$0-20	1.8%	0.2%	$16
20-40	11.3	3.5	56
40-60	21.6	11.9	102
60-80	21.6	17.0	145
80-100	14.7	15.9	200
100-150	16.6	23.2	258
150-200	5.0	9.0	331
200-250	2.5	5.3	395
250-500	3.3	8.8	491
Over 500	1.7	5.3	586

COMMENTS

This program is available only to taxpayers who claim itemized deductions on their state income tax returns. These taxpayers tend to fall disproportionately into moderate-income and higher-income brackets. Because of this tendency, along with both the state's graduated marginal tax bracket structure and the positive relationship between increases in the level of taxes paid and income, the tax relief provided by this program generally increases with income levels.

By allowing deductions for local taxes paid, this program makes it less expensive on an after-tax basis for individuals to consume a given level of publically provided services. It enables individuals living in communities with a high appetite for public services to avoid bearing the entire cost of the increase in taxes necessary to support such services, since a portion of the cost can be offset in the form of lower state income tax liabilities. This issue is less important at the state level than at the federal level, but still has ramifications for state fiscal policy.

The federal Budget Reconciliation Act of 1990 limited the aggregate amount of itemized deductions including this one, which can be claimed by taxpayers with adjusted gross income (AGI) over a certain amount, depending on the year involved. This amount was $124,500 in 1998 for joint-return filers and $62,250 for married, filing separately taxpayers. California law limits 1998 itemized deductions for taxpayers with AGI in excess of $116,777 for single-filers and married taxpayers filing separately, and $233,556 for joint-return filers.

Deduction:

MORTGAGE INTEREST EXPENSES

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Section 17201, which conforms to Internal Revenue Code Section 163.*

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	***PIT***
1996-97	*$2,770*
1997-98	*2,880*
1998-99	*3,030*

DESCRIPTION

This program generally allows taxpayers to deduct the amount of qualified mortgage interest expenses paid or accrued within a taxable year. Qualified mortgage interest includes interest on indebtedness secured by a taxpayer's residence, including interest incurred in acquiring, constructing, substantially improving, or refinancing the residence. Interest on indebtedness to purchase second homes and vacation homes, and interest on home-equity borrowing, also qualify for the deduction. The aggregate amount of indebtedness incurred to purchase, construct, or improve a home may not exceed $1 million (or $500,000 for a married individual filing a separate return). The total amount of interest on a home-equity loan generally may not exceed interest on indebtedness of more than $100,000 (or $50,000 for a married taxpayer filing a separate return).

RATIONALE

This program provides an incentive for home ownership. This is because most home purchases require mortgage financing, and this deduction reduces the net after-tax costs of such borrowing. It often is claimed that home ownership is worth encouraging on the grounds that it generates substantial public benefits, including neighborhood stability, promotion of civic responsibility, and encouragement of proper maintenance of residential structures by occupants.

DISTRIBUTION OF BENEFITS

The accompanying table indicates by income class the distribution of the mortgage interest deduction. The program provides a substantial

Mortgage Interest Expense Deduction

1998 Tax Year

Adjusted Gross Income ($000)	Percent of		Average Amount Claimed
	Total Taxpayers Benefitting	Total Amount Claimed	
$0-20	2.2%	0.3%	$104
20-40	12.7	3.9	266
40-60	22.9	12.8	481
60-80	21.0	18.2	745
80-100	14.2	16.7	1,020
100-150	15.7	23.8	1,307
150-200	4.7	8.9	1,642
200-250	2.3	5.1	1,925
250-500	3.0	7.6	2,179
Over 500	1.4	2.9	1,760

proportion of benefits to middle and upper-middle income classes, with over 70 percent of total deductions accruing to taxpayers

earning between $40,000 and $150,000 annually. The average benefit increases with income for all but the highest income class. The latter is due to a decline in the prevalence of mortgages in this income class, as well as the effect of limitations on itemized deductions.

COMMENTS

One of the side-effects of this program is that it encourages consumers to finance their homes and other purchases through borrowing, even if their income level is high enough to avoid the need to do so. In this sense, some might argue that the program provides some incentive for "over-borrowing." The program also encourages taxpayers to increase the amount they spend on housing because it reduces the after-tax costs of such expenditures. In addition, the program disproportionately benefits higher-income individuals, who are most likely to purchase their own homes. Higher-income individuals also realize greater tax savings for a given dollar amount of interest deductions due to their higher marginal income tax rates.

It should be noted that the federal Budget Reconciliation Act of 1990 placed additional limitations on the aggregate amount of itemized deductions (including this one) which can be claimed by a taxpayer with adjusted gross income (AGI) over a specified amount. California law also has limits on the aggregate amount of deductions which may be claimed by taxpayers. These limits are discussed under the program entitled, "Certain Taxes Paid."

We previously reviewed the economic and fiscal effects of this program (see Legislative Analyst's Report on the *1988-89 Tax Expenditure Budget: Overview and Selected Reviews,* and *The Personal Income Tax Itemized Deduction for Mortgage Interest Expenses*). Our major findings, which we believe still are applicable, were that although the program is at least partially successful in enabling certain taxpayers to buy homes, it is relatively inefficient. For example, the interest rate subsidies made available under the program provide "windfall" benefits to many taxpayers who would have purchased homes in the absence of the program, and encourage certain individuals to over-consume housing by buying bigger and more expensive homes than they otherwise would. The result may be that this program, coupled with other programs granting housing preferential treatment, results in a misallocation of resources. Reducing, but not eliminating, subsidies for housing could result in a more efficient allocation of resources while still preserving the social benefits that result from home ownership.

Given these findings, we previously have recommended that the Legislature consider the following options: (1) limit the amount of mortgage interest which may be deducted, (2) eliminate or limit the deduction for second homes and nonhousing expenses, (3) convert the current deduction into a maximum tax *credit* that reduces the overall regressivity of the derived tax benefit from the program and potentially reduces its revenue effect, and (4) use the savings from "tightening up" eligibility under this program to provide additional subsidies targeted at low-income households and first-time home buyers.

Deduction:

CHARITABLE CONTRIBUTIONS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).* *Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17201, 17251.5, 17275.5, 18648.5, 24344, and 24357 through 24359.1 which especially conform to Internal Revenue Code Section 170.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	*PIT*	*BCT*
1996-97	*$740*	*$39*
1997-98	*750*	*40*
1998-99	*810*	*41*

DESCRIPTION

This program allows taxpayers to deduct cash and specified noncash contributions to charities, religious organizations, governmental bodies, and other qualifying nonprofit organizations. The itemized deduction for PIT taxpayers is generally limited to 50 percent of adjusted gross income (AGI). The deduction available under BCT law may not exceed 10 percent of California taxable income. Contributions that exceed these percentage limitations may be carried forward for use in future tax years for up to five years.

RATIONALE

This program provides an incentive for taxpayers to donate cash, property, or services to qualifying charitable organizations. It does this by reducing the net after-tax cost to the giver making a contribution. The underlying rationale for the program is that qualifying charitable organizations provide socially beneficial services which are viewed as being worthy of indirect state financial support.

DISTRIBUTION OF BENEFITS

Charitable contributions are a flexible expenditure for many taxpayers, especially those in the higher-income categories. The concentration of the benefits of this program in the high income categories is shown in the accompanying figure. For example, over 40 percent of the deductions claimed are by those taxpayers earning at least $150,000 per annum, with over 20 percent by those earning $500,000 or more. The average deduction for those in the highest income class is more than four times as large as that for the next highest income class.

Charitable Contributions Deduction

1998 Tax Year

Adjusted Gross Income ($000)	Percent of		Average Amount Claimed
	Total Taxpayers Benefitting	Total Amount Claimed	
$0-20	1.8%	0.3%	$31
20-40	12.0	3.4	67
40-60	21.8	9.4	101
60-80	21.4	13.1	143
80-100	14.5	12.5	201
100-150	16.4	18.9	268
150-200	4.9	7.7	364
200-250	2.4	4.5	440
250-500	3.2	9.7	699
Over 500	1.7	20.5	2,879

COMMENTS

One effect of this program is that, for PIT taxpayers, the state government provides donors with a subsidy that, per dollar of donation, increases in value as the donor's marginal income tax bracket rises. Economists widely agree that permitting a deduction for charitable contributions tends to stimulate the volume of charitable donations, although there are differences of opinion regarding the exact nature and magnitude of this response.

Deduction:

CONTRIBUTIONS OF COMPUTERS AND SCIENTIFIC EQUIPMENT TO EDUCATIONAL INSTITUTIONS

Program Characteristics	
Tax Type:	Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 24357 and 24357.9.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**BCT**
1996-97	NA
1997-98	NA
1998-99	$4

DESCRIPTION

This program allows corporations to claim a larger-than-normal deduction for contributions of computers, software, and scientific equipment to institutions of higher education. The deduction is equal to the lesser of: (1) the taxpayer's "basis" in the equipment, plus one-half of the difference between this basis and the equipment's market value; or (2) twice the taxpayer's basis in the equipment. For example, if a computer manufacturer donated two computers and a printer to a community college with a total production cost of $500,000 and a market value of $800,000 under this program, the company could have claimed a deduction of $650,000 ($500,000 for the depreciable basis plus one-half of $300,000). Without this program, the deduction would have been limited to $500,000.

RATIONALE

This program provides companies with an incentive to donate computers, computer software, and other scientific equipment to colleges and universities. The view was that these donations would enhance student performance at less cost than if the equipment was directly provided by the government.

COMMENTS

This program, which was originally scheduled to sunset was continued in conformity with federal tax provisions pursuant to Chapter 322, Statutes of 1998 (AB 2797, Cardoza).

Deduction:

CONTRIBUTIONS MADE THROUGH TAX RETURN "CHECKOFFS"

Program Characteristics	
Tax Type:	Personal Income Tax (PIT)
Authorization:	California Revenue and Taxation Code Sections 18711 through 18444.

Estimated Revenue Reduction (In Millions)	
Fiscal Year	**Amount**
1996-97	Minor
1997-98	Minor
1998-99	Minor

DESCRIPTION

This program allows taxpayers to make certain tax-deductible contributions simply by designating a specific contribution amount for one or more specified purposes on their state income tax return.

The recipient programs to which such tax deductible "check-off" contributions may be designated under this provision include:

- California Fund for Senior Citizens.
- California Seniors' Special Fund.
- Endangered and Rare Fish Fund.
- Wildlife and Plant Species Conservation and Enhancement Account (in the Fish and Game Preservation Fund).
- State Children's Trust Fund.
- Alzheimers' Disease and Related Disorders Research Fund.
- California Breast Cancer Research Fund.
- California Public School Library Protection Fund.
- California Firefighters' Memorial Fund.
- California Drug Abuse Resistance Education Fund (D.A.R.E.).
- California Military Museum Fund.

RATIONALE

his program provides an incentive for taxpayers to make donations to specified programs. The underlying rationale for this is that these programs are socially beneficial, and viewed as deserving of governmental encouragement and financial support.

COMMENTS

These check-off contributions on state tax returns are deductible on federal income tax returns as itemized charitable deductions because they are contributions to a state government. For state income tax purposes, this program provides that they are deductible charitable contributions on the income tax return for the year in which the check-off contributions were made.

Deduction:

EMPLOYEE BUSINESS AND MISCELLANEOUS EXPENSES

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Sections 17072,17076, 17201, 17269, and 17270, which partially conform to Internal Revenue Code Sections 67, 68, 162, and 212.

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	**PIT**
1996-97	$400
1997-98	420
1998-99	450

DESCRIPTION

This program allows a taxpayer to deduct from gross income a portion of certain unreimbursed expenses. These include:

- Business expenses, including travel, meals, entertainment, and lodging.
- Miscellaneous expenses related to: (1) producing or collecting taxable income; (2) management, conservation, or maintenance of income-producing property; and (3) tax return preparation fees.

Generally, a taxpayer may claim a deduction for 50 percent of meal and entertainment expenses to the extent that this 50 percent amount exceeds 2 percent of the taxpayer's federal adjusted gross income (AGI). Prior to 1995, taxpayers could deduct 80 percent of meals and entertainment expenses—a percentage that was reduced pursuant to Chapter 881, Statutes of 1993 (SB 671, Alquist).

RATIONALE

This program provides tax relief to employees on the grounds that qualifying expenditures are a direct cost of earning income and, therefore, should be deductible.

DISTRIBUTION OF BENEFITS

This program is used by all income groups, but most heavily by those in the middle-income categories. Over three-quarters of taxpayers benefitting from the deduction earn $100,000 annually or less. In terms of benefit dollars, however, these taxpayers receive only about half of the deductions claimed.

Employee Business and Miscellaneous Expense Deduction

1998 Tax Year

Adjusted Gross Income ($000)	Percent of: Total Taxpayers Benefitting	Percent of: Total Amount Claimed	Average Amount Claimed
$0-20	2.1%	0.4%	$77
20-40	12.5	5.1	153
40-60	24.1	15.1	235
60-80	22.7	18.1	298
80-100	14.6	15.4	393
100-150	15.5	22.6	546
150-200	3.9	7.9	755
200-250	1.7	3.4	762
250-500	2.2	6.2	1,074
Over 500	0.9	5.8	2,455

COMMENTS

This program provides an incentive for employers to require, and employees to be willing to incur, certain job-related expenses. For example, the program increases the likelihood that an employee will be willing to pay his/her own way to a business conference, particularly if the conference is of personal interest because of its location or the professional opportunities it offers.

Federal and California tax law place additional limitations on the aggregate amount of deductions, such as this one, which can be claimed by a taxpayer with AGI over a specified amount. These income limits are discussed under the section regarding the deduction for "Certain Taxes Paid."

Deduction (Accelerated Depreciation):

AMOUNTS IN EXCESS OF STRAIGHT-LINE

Program Characteristics	
Tax Type:	Personal Income Tax (PIT). Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 17201, 24349, and 24354.1, which generally conform to Internal Revenue Code Sections 167 and 168.

Estimated Revenue Reduction (In Millions)		
Fiscal Year	**PIT**	**BCT**
1996-97	$287	NA
1997-98	294	NA
1998-99	305	NA

DESCRIPTION

Depreciation deductions enable taxpayers to recover their investments in income-producing assets, such as equipment and buildings, over specified periods of time. This program allows taxpayers to claim depreciation deductions in excess of "straight- line" depreciation on physical assets that are used in the production of income. Under the traditional straight-line depreciation method, a property's value is depreciated evenly over its useful economic life span.

Under this program, several more-generous accelerated depreciation methods are allowed. The permitted methods vary, depending on the type of property involved and when it is placed in service. These alternative methods include: (1) 200 percent, 150 percent, and 125 percent *declining-balance* methods; (2) the *sum-of-years-digits* method; and (3) other methods, such as the *sinking-fund* method.

Accelerated depreciation methods enable taxpayers to recover the costs of replacing their income-producing capital assets sooner than they otherwise would, through the deferral of tax liabilities, and thereby realize an increased rate of return on investments. For example, if a machine purchased for $20,000 had a useful life of 20 years and a salvage value of $2,000 after this period of time, under the straight-line method, the taxpayer could claim a depreciation deduction of $900 per year.

In contrast, under the 200 percent declining balance method, the taxpayer could claim an annual depreciation allowance twice the percentage amount permitted under the straight-line method. Thus, the first year's depreciation allowance for this property would be $1,800.

RATIONALE

By enabling taxpayers to defer some of their tax liabilities, the program provides an incentive for taxpayers to invest in income-producing assets. This is due to the fact that the deferral of tax liabilities amounts to an interest-free loan from the government, which increases the rate of return on capital investments. In addition, such tax deferments reduce investment payback periods, thus improving the financial liquidity of investors. Another rationale for the program is that it compensates property owners for the failure of the tax code to adjust the depreciable basis of property upward over time for the effects of inflation.

COMMENTS

Estimated revenue reductions for PIT under the accelerated depreciation program are for equipment and property (including rental property) and are based on federal estimates adjusted for California. The BCT estimates are not provided since comparable federal data are not available and since California has not fully conformed to the modified accelerated cost recovery system (MACRS) for depreciation.

In theory, depreciation allowances are intended to permit taxpayers to deduct the true economic costs of using assets that are incurred in the production of their income. Another way of looking at this is that depreciation allowances compensate taxpayers for the loss in productive capability of their income-producing property as it ages, so that, at the end of the property's life, the accumulated depreciation benefits permit it to be replaced. The revenue reductions associated with this program are based on the cost of allowable depreciation above and beyond that allowed under the straight-line method.

From a pure economic perspective, however, the technically correct measure of depreciation-related tax expenditure costs is the amount by which *actual* depreciation claims (however computed) exceed *pure* economic depreciation (that is, the decline in physical productivity of an asset) over time. This technically correct tax expenditure amount is likely to be less than that reported above, because the tax code does not adjust the depreciable basis of property for inflation. Many view the mid-point asset depreciation range (ADR) system based on 150 percent declining balance depreciation as a reasonable approximation of the economic life of corporate capital investment. The ADR system was used for federal purposes between 1971 and 1980, and assigned particular classes of assets with a prescribed useful life.

Deduction (Accelerated Depreciation):
POLLUTION CONTROL EQUIPMENT

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).* *Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17250 and 24372.3, which generally conform to Internal Revenue Code Section169.*

Estimated Revenue Reduction
(In Millions)

Fiscal Year	PIT	BCT
1996-97	—	NA
1997-98	—	NA
1998-99	—	NA

DESCRIPTION

This program allows taxpayers to depreciate the cost of pollution control facilities over a 60-month period, as opposed to a 10-year period which would otherwise apply. Qualifying facilities must be located within California and be appropriately certified by the California Air Resources Board or the State Water Resource Control Board.

RATIONALE

This program provides tax relief for businesses that are required by federal, state, and/or local regulations to install pollution control equipment. This tax relief takes the form of allowing taxpayers to, in effect, defer some of their tax liabilities by giving them larger depreciation write-offs during the early years following an investment in qualifying pollution control equipment. This tax deferral amounts to an interest-free loan from the government, which, in turn, increases the financial ability of taxpayers to make such required investments.

COMMENTS

Revenue estimates for this program are based on federal sources. The PIT revenue reductions stemming from this program are included in the revenue reduction estimates in the earlier section "Amounts in Excess of Straight-Line." The BCT estimates are not provided due to the absence of comparable federal data upon which to base the estimates.

Deduction (Accelerated Depreciation):

REFORESTATION EXPENDITURES

Program Characteristics	
Tax Type:	Personal Income Tax (PIT). Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 17201, 17278.5, and 24372.5, which partially conform to Internal Revenue Code Section 194.

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT	BCT
1996-97	NA	NA
1997-98	NA	NA
1998-99	NA	NA

DESCRIPTION

This program allows PIT and BCT taxpayers to amortize over a seven-year period up to $10,000 per year of certain qualifying reforestation expenditures. Qualifying expenditures include the direct costs of forestation and reforestation, including site preparation, seeds or seedlings, labor, and equipment costs.

RATIONALE

This program apparently is intended to give taxpayers an incentive to reforest private lands where logging and timber-related activities have depleted available stocks of timber. Thus, the program provides an incentive for increasing the future supply of harvestable timber. It accomplishes this by permitting taxpayers to recover their capital costs more quickly, thereby deferring tax liabilities. The tax deferral amounts to an interest-free loan from the government, which, in turn, increases the rate of return on such investments. Rapid amortization for activities with lengthy payoff periods, such as reforestation, also dramatically improves the cash-flow position of investors, and thus, their financial liquidity.

COMMENTS

California law is the same as federal law with the following modification: effective for taxable years beginning after 1996, California law limits the tax deduction to expenses associated with qualified timber located in California. In contrast, for income years beginning before 1997, there was no limitation as to where the timber property had to be located.

Deduction (Accelerated Depreciation):

PROPERTY USED IN ECONOMICALLY DEPRESSED AREAS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT). Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17266, 17267.6, 17268, 18036, 24356.4, and 24356.8.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT	BCT
1996-97	NA	NA
1997-98	NA	NA
1998-99	NA	NA

DESCRIPTION

This program allows taxpayers to claim accelerated depreciation write-offs for certain qualified business property used in designated economically depressed areas of the state, including an Enterprise Zone, Local Agency Military Base Recovery Area (LAMBRA), Targeted Tax Area, and the Los Angeles Revitalization Zone (LARZ). In general, the program permits a taxpayer to “expense” (that is, *immediately* deduct as a current business-related expense) a certain portion of the costs of these types of property. Sunset dates under two components of the program are January 1, 1998 (LARZ) and January 1, 2003 (LAMBRA).

RATIONALE

This program provides an incentive for taxpayers to make business investments in economically depressed areas of the state. It does this by enabling taxpayers to use expensing to defer tax liabilities. This deferral amounts to an interest-free loan from the government, which, in turn, increases the rate of return on taxpayers' investments and improves their cash-flow position. The underlying rationale for this program is that the stimulation of investments in economically depressed areas can lead to improved economic conditions. This in turn, can result in various social benefits, including reduced state costs for unemployment and welfare benefits.

COMMENTS

Taxpayers are permitted to expense a certain portion of the cost of qualified property under this program, depending upon the type of area. In the case of property located in a Targeted Tax Area (for taxable years beginning after 1997), or Enterprise Zone (for taxable years after 1996), a taxpayer can expense 40 percent of the cost of the property subject to a dollar limit of $100,000 in years one and two of the area's designation, $75,000 in years three and four, and $50,000 thereafter. The remaining 60 percent of a property's depreciable basis is subject to being written-off using standard depreciation options.

In the case of property located in a LAMBRA, for taxable years beginning after 1994 but before 2003, taxpayers may elect to expense a portion of the cost of qualifying property. The cost that may be taken into account is $5,000 for the first two years following designation as a LAMBRA, $7,500 for the second and third taxable years after designation, and $10,000 for every year thereafter.

In the case of property located in LARZ, for taxable years beginning after 1991 and before 1998, the taxpayer may elect to expense property purchased for exclusive use in a trade or business located within the zone.

In each case, the expensing deduction is recaptured (included in income) if the property ceases that is, to be used in the designated area at any time before the close of the second taxable year after the property was placed in service.

Deduction (Accelerated Depreciation):

AGRICULTURAL COSTS

Program Characteristics	
Tax Type:	Personal Income Tax (PIT). Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 17201, 24369, and 24377, which conform to Internal Revenue Code Sections 175 and 180.

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT	BCT
1996-97	$7	$7
1997-98	7	7
1998-99	7	8

DESCRIPTION

This program allows taxpayers to "expense" (that is, *immediately* deduct as a current business-related expense) soil, water conservation, and fertilizer expenditures, up to a maximum of 25 percent of their gross income from farming. Any qualified expenses in excess of the 25 percent limitation, however, may be carried forward and expensed in future years. In the absence of this program, the qualifying expenditures would be considered capital expenditures to be written off.

RATIONALE

This program provides a tax incentive to encourage certain types of farming-related conservation investments, particularly those with lengthy developmental and payback periods. The program accomplishes this by allowing very rapid cost write-offs that, in effect, permit the deferral of taxes on farming income. This amounts to an interest-free loan from the government, which in turn, raises the rate of return on qualifying investments and shortens their payback periods. The program also has been rationalized as a way of simplifying record-keeping for small farming businesses.

COMMENTS

Qualifying expenditures include those for: the treatment or moving of earth (including leveling, grading, furrowing, and other improvements); the fertilization of land; the construction of water channels, drainage ditches, and similar water conservation projects; the eradication of brush; and the planting of windbreaks.

The federal 1986 Tax Reform Act restricted a taxpayer's ability to expense agricultural costs for federal tax purposes to those expenditures which are consistent with a soil conservation plan approved by the Soil Conservation Service of the Department of Agriculture. California has adopted these limitations as well.

Deduction (Accelerated Depreciation):

EMPLOYER-PROVIDED RIDESHARING PROGRAM COSTS

Program Characteristics	
Tax Type:	Personal Income Tax (PIT). Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 17090, 17149, and 24343.5.

Estimated Revenue Reduction (In Millions)		
Fiscal Year	**PIT**	**BCT**
1996-97	NA	NA
1997-98	NA	NA
1998-99	NA	NA

DESCRIPTION

This program allows taxpayers to "expense" (that is, *immediately* deduct as a current business-related expense) costs associated with providing ridesharing programs for employees. The deduction covers a taxpayer's expenses to provide for: company commuter vans or bus service to employees; subsidizing employee commuting expenses in third-party vanpools, private commuter buses, or subscription taxipools; free parking facilities for carpools; and certain other ridesharing programs. In addition, taxpayers are allowed an accelerated (36-month) depreciation deduction for costs of facility improvements for employee ridesharing, bicycling, and walking programs.

RATIONALE

This program provides an incentive for employers to establish ridesharing programs for their employees. It does this by allowing employers to partially offset their costs for sponsoring such programs by deferring tax payments. The program is based on the argument that state tax incentives are needed to encourage employees and employers to use ridesharing programs so as to alleviate traffic congestion, reduce air pollution, and reduce gasoline consumption.

COMMENTS

It is possible that certain noncapital ridesharing expenses, such as subsidies for monthly transit passes, may be deductible by the employer as a business expense, even *without* this program. This is because an employer may consider such expenses to be "ordinary and necessary" in some situations and therefore deductible as a regular business expense. Thus, in some cases, employers benefit from the program only to the extent that it allows them to recover their costs for capital-related ridesharing expenditures (such as for vehicles and facilities) over a shorter- than-normal time period.

The argument traditionally put forth in explaining this type of program revolves around achieving the optimal amount of driving by individuals. Because of the social costs associated with car travel (like air and noise pollution), individuals do not bear the entire costs of car transportation. As a result, an over-consumption of car travel by individuals may occur. By lowering the costs of ridesharing and other related policies, this program makes alternative forms of transportation more attractive, leading to an increase in participation. Proponents argue that the result of such intervention is a decrease in congestion and a more efficient deployment of transportation-related economic resources.

Deduction (Accelerated Depreciation):
EXPLORATION, DEVELOPMENT, RESEARCH, AND EXPERIMENTAL COSTS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).* *Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17201, 17260, 17681, 24423, and 24365, which generally conform to Internal Revenue Code Sections 174, 193, and 263A.*

Estimated Revenue Reduction
(In Millions)

Fiscal Year	*PIT*	*BCT*
1996-97	*$7*	*$81*
1997-98	*10*	*87*
1998-99	*10*	*93*

DESCRIPTION

This program allows taxpayers to either "expense" (that is, *immediately* deduct as a current business-related expense) or amortize more rapidly the costs of (1) research or experimental activities, and (2) qualified mining-related exploration and development costs for mines and mineral deposits.

Qualified expenditures associated with *research and experimental* activities may be either deducted currently or amortized over a 60-month period at the election of the taxpayer. The option to immediately deduct versus amortize research and experimental expenditures applies only to expenditures that are deemed reasonable.

Qualified *exploration and development* activities may be either expensed or, for development activities only, amortized at the taxpayer's election. *Exploration* expenses are those paid prior to the development period. *Development* expenses are those that are incurred after the existence of ores or minerals in commercially marketable quantities has been established. If amortization is chosen over expensing, this must occur over a 10-year period.

RATIONALE

This program provides an incentive for taxpayers to undertake research and experimental projects, and to locate and recover minerals from the earth, by enabling them to more-quickly deduct their associated costs. This faster deduction, in effect, enables taxpayers to defer their taxes. The tax deferral amounts to an interest-free loan from the government, which, in turn, raises the real rate of return on qualifying expenditures and improves the taxpayer's cash-flow position.

The underlying rationale for the program is that research and experimental projects, and exploration and development activities—while often of great long-term importance to the state and its citizens—are inherently risky, and often do not generate any income for the taxpayer until a considerable period of time has passed.

Deduction (Accelerated Depreciation):

CIRCULATION COSTS FOR PERIODICALS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).* *Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17201 and 24364, which conform to Internal Revenue Code Section 173.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	*PIT*	*BCT*
1996-97	*$2*	*$2*
1997-98	*2*	*2*
1998-99	*2*	*2*

DESCRIPTION

This program allows taxpayers to "expense" (that is, deduct *immediately* as a current business-related expense) costs for establishing, maintaining, or increasing the circulation of a periodical. Alternatively, the program allows such costs to be amortized over a three-year period. In the absence of this program, these costs would have to be capitalized, and then amortized over whatever period of time the taxpayer was able to determine that the expenditure resulted in increased income.

Suppose for example, that a taxpayer spends $100,000 for advertising and promotional activities during the current year in order to increase over the next five years the circulation of a magazine the taxpayer publishes. This program allows the taxpayer to deduct the entire $100,000 as an expense on his or her current-year tax return or, if the taxpayer prefers, deduct it over a three-year period—as opposed to having to spread the $100,000 deduction over five years.

RATIONALE

The rationale for this program appears to be administrative in nature, and relates to the difficulty of identifying exactly when the benefits of circulation-related expenses are realized. In principle, these costs should be deductible when the benefits they generate are experienced in the form of increased income. In practice, however, it often is difficult to determine which individual periodical subscriptions result from advertising or promotional expenses, including how to treat multiple renewals of subscriptions over time. For this reason, it is simpler from a tax administration perspective not to require taxpayers to capitalize their costs, but rather to allow taxpayers to deduct them either immediately or over a fairly moderate, specified time period.

Deduction (Accelerated Depreciation):

SMALL BUSINESS EXPENSING

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Sections 17201 and 17255, which generally conform to Internal Revenue Code Section 179(b)(1).*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT
1996-97	$2
1997-98	5
1998-99	11

DESCRIPTION

This program permits small businesses to *expense* rather than *depreciate* up to a specified amount of business personal property acquired each year. For 1997, the maximum expensing allowed was $13,000. This amount will increase to $16,000 for 1998 and incrementally thereafter until it reaches $25,000 in 2003. However, the expensing deduction cannot exceed the taxable income derived from the associated trade or business during the tax year involved. This program does not apply to C corporations, but does apply to most small businesses (partnerships, proprietorships, limited liability corporations, and S corporations).

RATIONALE

This program provides tax relief to small businesses for the purchase of business personal property (such as adding machines, furniture, and computers). It accomplishes this by allowing businesses to offset their costs by deferring tax payments. The tax deferral amounts to an interest-free loan from the government, which in turn improves the taxpayer's cash-flow situation and rate of return.

COMMENTS

For 1997, the *federal* government allowed taxpayers to expense up to $18,000 of business personal property. Beginning in 1998, this amount is scheduled to incrementally increase until the year 2003, when the annual expensing limit will be $25,000. For both federal and California purposes, the deduction under this program is reduced (but not below zero) by the excess of the total investment in qualified property over $200,000 in a given tax year. The excess of the deduction over otherwise-allowable depreciation is recaptured if the property ceases to be used predominantly in the particular trade or business before the end of its recovery period.

Deduction:

CARRYFORWARD OF NET OPERATING LOSSES

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT). Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17041, 17276 through 17276.3, 24416, 24416.1 through 24116.3, 25108, and 25110, which partially conform to Internal Revenue Code Section 172.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT	BCT
1996-97	$97	$360
1997-98	102	365
1998-99	90	375

DESCRIPTION

General Provisions. This program generally allows taxpayers to carryforward, for up to five years, a portion of their net operating losses (NOLs). Generally, most businesses may carryforward 50 percent of their "excess" net operating losses in any given year (that is, the unrecovered losses that exceed their taxable incomes in that year) to offset their income in the following five years, and thereby reduce their cumulative state tax liabilities. For an NOL incurred prior to August 6, 1997, a 15-year carryover is permitted.

Extensions to the carryover period are available for NOLs incurred prior to or during 1991 and 1992, when NOL deductions were temporarily suspended due to state budgetary problems associated with the early-1990s' recession. Additional restrictions on NOL deductibility apply to water's-edge corporations and those taxpayers subject to income allocation and apportionment. California does not allow NOL carrybacks (that is, the application of deductions to a previous year's income), unlike treatment under the parallel federal program.

Special Provisions. Special rules apply to NOLs incurred by small businesses, new businesses, bankrupt taxpayers, and businesses operating in an Enterprise Zone, the Los Angeles Revitalization Zone (LARZ), or a Local Agency Military Base Recovery Area (LAMBRA). Businesses operating in Enterprise Zones, the LARZ, or LAMBRAs may carryforward 100 percent of their net operating losses for 15 years, and use them to offset income earned in future years attributable to those designated areas. Under certain circumstances, 100 percent carryover also is available to small and new businesses, but with truncated carryover periods. For bankrupt taxpayers, a ten-year carryover period applies.

Example. Consider a business that incurs an excess net operating loss of $70,000 during one tax year. If the business earns a net profit of $25,000 in the second year and $40,000 in the third year, under this program using a 50 percent carryforward, the taxpayer can apply $25,000 in losses to the second-year profits, thus completely eliminating his tax liability in that year. In addition, the $10,000 in net operating losses "left over" can be applied to the third-year profits, reducing his taxable income in that year to $30,000.

RATIONALE

This program is intended to provide tax relief for businesses that incur operating losses. In addition, it is an attempt to recognize that a taxable year is an arbitrary period of time with respect to measuring income and losses. For example, a firm might incur expenses in an early year (that result in net operating losses), in order to produce income (resulting in profits) in a later year. From an economic perspective, these losses and profits are related, and basing the firm's tax only on its reported net profits in individual years, but not accounting for loss years, overstates the net economic income resulting from the investment for the period as a whole.

The tax benefits associated with carryforward of net operating losses is heavily weighted towards smaller business in terms of the proportion of those claiming the deduction. Figure 1 below indicates that almost three-quarters of those claiming the deduction are from businesses with total receipts of less than $1 million. Total benefits are more evenly distributed across all sizes of industry, although a large proportion goes to businesses with total receipts of $1 billion or more. Figure 2 shows the distribution of benefits according to type of industry.

DISTRIBUTION OF BENEFITS

The tax benefits associated with carryforward of net operating losses is heavily weighted towards smaller business in terms of the proportion of those claiming the deduction. Figure 1 below indicates that almost three-quarters of those claiming the deduction are from businesses with total receipts of less than $1 million. Total benefits are more evenly distributed across all sizes of industry, although a large proportion goes to businesses with total receipts of $1 billion or more. Figure 2 shows the distribution of benefits according to type of industry.

Figure 1

Carryforward of Net Operating Losses Deduction by Receipt

1998 Income Year

	Percent of	
Total Receipts (In Millions)	**Total Taxpayers Benefitting**	**Total Amount Claimed**
Under $1	73.0%	10.6%
1–10	20.9	17.5
10–50	4.1	15.1
50–100	0.4	7.2
100–500	1.2	18.3
500–1,000	0.2	5.0
Over 1,000	0.3	26.3

Figure 2

Carryforward of Net Operating Losses Deduction by Industry

1998 Income Year

	Percent of		
Industry Type	**Gross State Product**	**Total Taxpayers Benefitting**	**Total Amount Claimed**
Agriculture, Forestry & Fishery	3.0%	2.2%	1.9%
Construction	3.8	8.1	3.2
Manufacturing	15.9	9.3	26.5
Services	25.1	38.7	16.8
Trade	18.2	20.8	14.4
Finance, Real Estate & Insurance	25.9	18.7	29.1
Utilities & Transportation	8.2	2.1	8.0

COMMENTS

For federal tax purposes, a 100 percent carryforward of NOLs for 20 years is permitted along with a two-year carryback. The carrybacks must be applied, when possible, *before* any carryforward is allowed.

Deduction:

PERCENTAGE RESOURCE DEPLETION ALLOWANCE

Program Characteristics	
Tax Type:	Personal Income Tax (PIT). Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 17681, and 24831 through 24833.

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT	BCT
1996-97	$10	$25
1997-98	10	30
1998-99	10	30

DESCRIPTION

This program allows taxpayers to claim a fixed percentage deduction for resource depletion, which generally proves to be in excess of the deduction amount that otherwise would be allowed under the normal cost-depletion method. Under the program, a specified percentage of gross income (depending on the type of resource involved) may be deducted as a depletion allowance, except that this depletion amount cannot exceed 50 percent of a taxpayer's related net income before applying the depletion deduction, or 100 percent in the case of oil and gas properties.

California conforms to federal tax law regarding the percentage depletion for oil and gas wells, and for geothermal deposits. Depletion rates are limited to: (1) 22 percent for regulated domestic natural gas; (2) 10 percent for natural gas from geopressurized brine; (3) 15 percent for domestic crude oil and natural gas from certain independent producers; and (4) 15 percent for geothermal deposits located in the U.S. California also adopts federal percentage depletion provisions for depletable assets other than oil, gas, and geothermal deposits, and with regard to natural resources located in continental shelf areas.

Under this program, a taxpayer who owns and operates a natural gas well that produces, for example, $100,000 in gross income, is allowed to claim a deduction for 22 percent of this amount ($22,000). This deduction is intended to offset the physical and economic resource costs associated with depleting the oil reserves in the well.

RATIONALE

This program provides an incentive for taxpayers to explore for and develop oil, gas, and other mineral resources. The underlying rationale for the program is that such activities can be extremely costly and inherently risky.

COMMENTS

The term "percentage depletion" differs from "cost depletion." *Cost* depletion allows for the recovery of the initial costs of discovering, purchasing, and developing mineral reserves over the period during which a reserve produces income. Each year the taxpayer deducts the portion of the cost that is proportional to the fraction of the resource reserve that has been depleted in that year. Thus, under *cost* depletion, the amount of cost recovered through depletion allowances cannot exceed the original cost of acquiring and developing the reserve.

In contrast, under the *percentage* depletion method, a taxpayer deducts a fixed percentage of *gross income* from the reserve as a depletion allowance, regardless of the amount actually invested.

Deduction:

RESERVE ALLOWANCE FOR BAD DEBTS

Program Characteristics	
Tax Type:	*Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Section 24348, which generally conforms to Internal Revenue Code Section 166.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	*BCT*
1996-97	*NA*
1997-98	*NA*
1998-99	*NA*

DESCRIPTION

This program allows financial institutions to elect to use the "reserve allowance" for deducting their losses from bad debts. Under this method, a deduction is allowed for a reasonable addition to what is known as a "bad debt reserve account." These are accounts set up by the taxpayer as an allowance against the possibility that some debts may be uncollectible. The amount allowed in the account is generally based on the taxpayer's past experience with bad debts.

During a given year, debts that become uncollectible are charged against a taxpayer's bad debt reserve, which reduces the balance in the reserve. The taxpayer makes additions to the reserve account to (1) offset the amount of bad debts which have been charged off and (2) allow for future bad debt charge-offs (attributable to increases in accounts receivables). The deduction is allowed for both of these kinds of additions to a bad debt reserve. In the absence of the program, the taxpayer would be required to use the "specific charge-off method," under which the taxpayer would deduct bad debts only when they are found to be uncollectible.

RATIONALE

This program provides tax relief to financial institutions that incur bad debts, to the extent that it allows them to claim a deduction for bad debt losses prior to the time the losses actually occur. The tax relief takes two forms. First, the early claiming of bad debt losses increases the "present value" of the deduction for bad debts to the taxpayer. Second, by "spreading out" deductions for bad debts, the program lessens the chance that a taxpayer will be unable to deduct the full amount of such debts, due to having insufficient offsetting income in any one year.

COMMENTS

According to federal reports, the federal deduction (to which California generally has conformed) for bad debt reserves was first allowed in 1947, when there was fear of a postwar economic downturn. It was intended to reflect the banking industry's experience with bad debts during the depression period. The difference in annual bad debt deductions between the reserve and specific charge-off methods could be a gain or a loss in any given year.

Deduction:

EMPLOYEE STOCK OWNERSHIP PLANS

Program Characteristics	
Tax Type:	Personal Income Tax (PIT). Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 18042 and 24601 through 24612, which generally conform to Internal Revenue Code Sections 401 through 424, and 1042.

Estimated Revenue Reduction
(In Millions)

Fiscal Year	PIT	BCT
1996-97	$1	$5
1997-98	1	3
1998-99	1	3

DESCRIPTION

This program allows California employers that provide employee stock ownership plans (ESOPs) to their employees a PIT and BCT deduction for dividends paid to an ESOP, when those dividends are paid by the ESOP to participants or used to retire ESOP debt. It also allows the deferral of capital gains on the sale of stock to an ESOP if the proceeds are used to acquire a similar type security.

RATIONALE

This program conforms California ESOP provisions with federal law, thereby simplifying tax administration and compliance. It also gives an incentive to employers to provide their employees with this form of compensation as an option.

COMMENTS

Effective for income years beginning after 1997, this deduction is unavailable to Subchapter S corporations under both California and federal law.

Credit (Person Specific):

PERSONAL EXEMPTION

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Sections 17054, 17054.1, 17056, and 17733.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT
1996-97	$800
1997-98	825
1998-99	860

DESCRIPTION

This program allows *all* individual taxpayers to claim a personal exemption tax credit. The amount of the credit depends on the taxpayer's filing status. The credit is indexed annually, based on the California Consumer Price Index. For 1998, the credit amounts are $70 for single taxpayers and $140 for married couples filing jointly. Nonresidents who are required to file a California tax return are allowed partial personal exemption credits, based on the ratio of their California adjusted gross income (AGI) to their total (multistate) AGI.

The exemption credits are phased out for taxpayers whose AGI exceeds a threshold amount. For 1998, for single taxpayers the credit is reduced by $6 for each $2,500 or fraction thereof by which the taxpayer's AGI exceeds $116,777; for married taxpayers filing jointly, the credit is reduced by $12 for each $2,500 or fraction thereof by which the taxpayer's AGI exceeds $233,556.

In addition, California's personal exemption credits may be reduced or eliminated altogether under the state's Alternative Minimum Tax (AMT).

RATIONALE

This program provides broad-based tax relief to California taxpayers. The rationale for the program is that taxpayers have a certain minimum amount of expenses and this program provides assistance through the tax system in meeting those expenses.

DISTRIBUTION OF BENEFITS

The personal exemption credit is a program which benefits primarily lower- and moderate-income groups. As shown in the accompany-

Personal Exemption Credit

1998 Tax Year

Adjusted Gross Income ($000)	Percent of Total Taxpayers Benefitting	Percent of Total Amount Claimed	Average Amount Claimed
$0-20	22.8%	14.2%	$57
20-40	26.9	24.1	82
40-60	19.9	21.9	101
60-80	12.5	16.0	117
80-100	7.3	9.8	124
100-150	7.5	10.2	124
150-200	2.0	2.8	130
200-250	1.0	1.2	122
250-500	0.1	0.1	NA
Over 500	—	—	—

ing table (see next page), almost 70 percent of tax returns receiving benefits and over 60 percent of the total benefits received go to taxpayers earning $60,000 or less annually. As indicated above, there are income limits placed on the program, making its use more infrequent in the higher-income categories. Average benefits are quite similar across income groups except in the lowest category, where low tax liabilities can keep the entire credit from being utilized (the credit is not refundable).

COMMENTS

Federal law allows exemptions in the form of deductions from AGI, as opposed to the use of tax credits, as under this program. The federal exemption amount for 1998 is $2,700 per taxpayer, taxpayer's spouse, and for each dependent.

Credit (Person Specific):

DEPENDENT EXEMPTION

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Sections 17054, 17054.1, 17056, and 17733.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	*PIT*
1996-97	*$380*
1997-98	*390*
1998-99	*1,356*

DESCRIPTION

This program allows all taxpayers to claim a tax credit for each of their dependents. For 1997, the credit amount was $68 per dependent. Under California's 1997 tax relief package, this amount was to be increased to $120 in 1998 and $222 in 1999. However, these amounts were changed as part of the 1998-99 budget agreement, in Chapter 322, Statutes of 1998 (AB 2797, Cardoza). The amount for 1998 was increased to $253 and the amount for 1999 will be $227. In addition, the exemption amount will be indexed annually based on the California Consumer Price Index, beginning in 2000.

The phase-out provisions with respect to the credit for high-income taxpayers and requirements for nonresident taxpayers are the same as those listed under the immediately preceding tax credit program "Personal Exemption." In addition, California's dependent exemption credits can be reduced or eliminated altogether under the state's alternative minimum tax (AMT).

RATIONALE

This program provides tax relief to taxpayers who are financially responsible for the support of dependents, such as children or the aged. The rationale for this program is that such financial responsibilities reduce the ability of individuals to pay taxes.

DISTRIBUTION OF BENEFITS

The accompanying table shows the distribution of benefits from this program, based on income class. The program is one which largely benefits taxpayers in the lower- and moderate-income categories. Roughly two thirds of all returns receiving some benefit from the program involve taxpayers earning $60,000 or less on an annual basis. Over one-

Dependent Exemption Credit

1998 Tax Year

Adjusted Gross Income ($000)	Percent of		
	Total Taxpayers Benefitting	Total Amount Claimed	Average Amount Claimed
$0-20	13.9%	2.3%	$55
20-40	31.0	21.3	231
40-60	20.4	27.5	453
60-80	13.7	19.9	486
80-100	8.4	11.8	472
100-150	8.5	12.0	474
150-200	2.4	3.3	449
200-250	1.1	1.5	435
250-500	0.7	0.4	207
Over 500	—	—	—

half of the total benefits from the program also go to this group of taxpayers. Average benefits are very similar over most income classes. They are smaller only for the two highest and two lowest income categories, due to the effect of income limits and the nonrefundable nature of the credit, respectively.

COMMENTS

Federal law allows a dependent exemption in the form of a *deduction* from adjusted gross income, as opposed to providing a tax *credit*, as under this program. The federal exemption amount for 1998 was $2,700 for each dependent. In general, California allows a dependent credit for everyone for whom a federal dependent exemption is allowed.

Credit (Person Specific):

BLIND EXEMPTION

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Sections 17054, 17054.1, 17056, and 17733.*

Estimated Revenue Reduction
(In Millions)

Fiscal Year	PIT
1996-97	$1
1997-98	1
1998-99	1

DESCRIPTION

This program allows a taxpayer who is blind to claim an additional personal exemption tax credit. The amount of this credit (which is indexed annually for inflation based on the California Consumer Price Index) is $70 for 1998.

RATIONALE

This program provides tax relief to those who are blind, based on the rationale that individuals with certain types of diminished physical abilities have increased expenses and/or decreased earnings potential.

COMMENTS

Instead of a tax credit, federal law (Internal Revenue Code Section 63 [f]) provides an additional deduction from adjusted gross income (AGI) for blind taxpayers who do not itemize their deductions. In 1998, the amount of this deduction is $850 for married taxpayers (whether filing separately or jointly) and surviving spouses, and $1,050 for single taxpayers.

Credit (Person Specific):

SENIOR EXEMPTION

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Sections 17054, 17054.1, 17056, and 17733.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT
1996-97	$81
1997-98	82
1998-99	87

DESCRIPTION

This program allows taxpayers over the age of 65 to claim an additional personal exemption tax credit. The amount of this credit (which is indexed annually for inflation) is $70 in 1998. In the case of a husband and wife filing a joint return, if both are over the age of 65, the amount of the credit is $140 in 1998.

RATIONALE

This program provides tax relief to those over the age of 65 under the rationale that such persons are more vulnerable to high medical or personal care expenses as a result of illness or infirmity.

COMMENTS

Federal law allows an additional deduction from adjusted gross income for taxpayers age 65 or over. For 1998 the amount of this deduction is $850 for married individuals (whether filing separately or jointly) and surviving spouses, and $1,050 for single individuals.

Credit (Person Specific):

RENTERS' CREDIT

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Section 17053.5.

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	***PIT***
1996-97	—
1997-98	—
1998-99	$133

DESCRIPTION

The renters' credit allows taxpayers to deduct a specified amount from their tax liabilities, providing that they rent their principal place of residence. For the years 1993 through 1997, the credit was suspended for reasons largely related to state budget problems. As part of the 1998-99 budget plan, (Chapter 322, Statutes of 1998 [AB 2797, Cardoza]), the credit was restored and modified. Beginning in the 1998 tax year, the credit will be $60 for single filers and $120 for joint filers, and will be available only on a *nonrefundable* basis. In addition, the credit is income-limited, with the single-return and joint-filer annual income limits set at $25,000 and $50,000, respectively. At various times, this program has allowed qualified renters to claim a *refundable* tax credit and was *not* income limited.

RATIONALE

The renters' credit provides tax relief to renters, and is intended to offset the property taxes that renters indirectly pay through their rental payments. Although landlords actually pay the property taxes on rental properties and are allowed to deduct them as a business expense, it is generally acknowledged that at least a portion of such payments are "passed-on" to tenants in the form of higher rental payments. Thus, proponents argue that in the absence of this program, renters would be treated inequitably relative to homeowners who receive the homeowners' exemption as a form of tax relief. As such, the credit is sometimes viewed as the renters' equivalent of the homeowners' exemption.

Another rationale often offered for the program is that it provides tax relief to renters, many of whom have low incomes. With its current structure of income limits, the credit will now only be received by renters with lower incomes.

DISTRIBUTION OF BENEFITS

As indicated above, the renters' credit program is limited to those taxpayers with lower and moderate incomes. The accompanying

Renters' Credit

1998 Tax Year

Adjusted Gross Income ($000)	Percent of Total Taxpayers Benefitting	Percent of Total Amount Claimed
$0-20	2.7%	0.1%
20-40	46.0	36.8
40-60	21.3	16.5
60-80	17.2	26.3
80-100	12.9	20.3
Over 100	—	—

table indicates the distribution of its benefits by income class both in terms of the numbers of returns and share of total benefits received. These distributional estimates are based on the past use of the program prior to its suspension, and adjusted for the effect of subsequent income limits.

COMMENTS

The renters' credit was established in 1972 with amounts ranging from $25 to $45, depending on the taxpayer's adjusted gross income. Program changes in 1976 resulted in a fixed dollar amount for the credit of $37. This amount was increased to $60 (for single taxpayers) and $137 (for joint and head-of-household filers) in 1979. In 1982, legislation established a separate credit amount of $99 for joint-custody, head-of-household taxpayers. This separate amount for joint-custody, head-of-household taxpayers was eliminated in 1987. The current credit amounts represent a reduction from $137 to $120 for married couples filing joint returns, heads of households, and surviving spouses. The $60 credit for single taxpayers has remained the same since 1979.

Originally, this program was funded through an annual General Fund appropriation because of requirements related to the discontinued Federal Revenue Sharing program. Under that program, the amount of federal funds available to the state depended partially on its level of "tax effort" relative to other states, which was computed by taking into account the state's level of revenue collections. Thus, by funding the renters' credit through an appropriation instead of a revenue reduction, the state was able to show a greater "tax effort" and thereby increase its revenue-sharing allocation. The program is currently classified as a revenue program.

Credit (Person Specific):

SENIOR HEAD OF HOUSEHOLD

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Section 17054.7.

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	**PIT**
1996-97	Minor
1997-98	Minor
1998-99	Minor

DESCRIPTION

This program allows elderly taxpayers who qualify as head of household to claim a personal income tax credit in an amount equal to 2 percent of their taxable income, not to exceed $860 in 1998. This credit is only available to taxpayers with adjusted gross income of less than $45,675.

RATIONALE

This program provides tax relief to elderly taxpayers 65 years or older who have low or moderate incomes. The rationale for this is that the ability of such individuals to pay taxes often is limited, given their income constraints and their need to provide for special retirement expenses, such as health care.

COMMENTS

This program was established by Chapter 1154, Statutes of 1990 (SB 389, Seymour) and applies to tax years beginning on January 1, 1990 and thereafter. The maximum credit amount is indexed annually for inflation, and the credit is not refundable.

Credit (Activity Based):

PRISON INMATE LABOR COSTS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).* *Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17053.6 and 23624.*

Estimated Revenue Reduction (In Millions)		
Fiscal Year	**PIT**	**BCT**
1996-97	Minor	Minor
1997-98	Minor	Minor
1998-99	Minor	Minor

DESCRIPTION

This program allows employers a tax credit equal to 10 percent of the wages they pay to each state prison inmate employed in a joint-venture program for the purpose of producing goods or services. For purposes of this program, a joint-venture employer is any public entity, nonprofit or for-profit entity, organization, or business which contracts with the California Department of Corrections for the purpose of employing inmate labor. These work programs are to be patterned after business operations found outside of prison, and priority consideration is given to inmate employment which will retain or reclaim jobs in California, support emerging California industries, or create jobs to fill a void in the labor market.

RATIONALE

This program provides an incentive for California businesses to use state prison inmate labor. The rationale for the program is that it will provide meaningful work to prison inmates that will enhance their prospects for employment once they are released from prison, and also will benefit the California economy. In addition, the wages earned by inmates are subject to deductions for taxes, prison room and board, restitution to crime victims, and support of the inmate's family.

COMMENTS

The revenue losses associated with this program are speculative due to uncertainties regarding the number of qualifying joint-venture programs and the annual compensation of those employed. This program was enacted by Proposition 139 in the statewide general election in November 1990.

Credit (Activity Based):

ACTIVITIES IN ENTERPRISE ZONES AND OTHER ECONOMICALLY DEPRESSED AREAS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).* *Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 7089, 17052.13, 17052.15, 17053.8, 17053.9, 17053.10, 17053.11, 17053.17, 17053.33, 17053.34, 17053.45, 17053.46, 17053.70, 17053.74, 17053.75, 23612, 23612.5, 23622, 23623, 23623.5, 23625, 23645, and 23646.*

Estimated Revenue Reductions

(In Millions)

Fiscal Year	PIT	BCT
1996-97	$50	$102
1997-98	58	107
1998-99	19	114

DESCRIPTION

These programs allow qualified taxpayers to claim tax credits for certain expenditures or income earned in economically depressed areas of the state, including those that have been designated as Enterprise Zones, Local Agency Military Base Recovery Areas (LAMBRA), the Los Angeles Revitalization Zone (LARZ) or, for specified types of activities, within Targeted Tax Areas and Manufacturing Enhancement Areas. There are three types of income tax credits available.

Wages Paid to Disadvantaged Persons. Employers can receive a credit equal to a portion of the wages paid to qualified "disadvantaged individuals." Generally, qualified individuals are those who were unemployed or economically disadvantaged prior to the date of hiring. For employers in Enterprise Zones, LAMBRA, LARZ, Targeted Tax Areas and Manufacturing Enhancement Areas, the available tax credit is 50 percent of the wages paid during the first year, 40 percent for the second year, 30 percent for the third year, 20 percent for the fourth year, and 10 percent for the fifth year. In addition, a credit of 50 percent of wages paid to area residents who were hired to do construction work within the zone was available to LARZ employers through 1997. A credit claimed under this program, together with the sales and use income tax credit (see below), is limited to the tax attributable to income from the designated area.

Credits are generally recaptured if employees are terminated prior to a prescribed time period (generally one year). Unused credits may be carried over and applied to offset taxes on income from the area in succeeding tax years. Generally, the available credit is reduced to the extent other credits are granted to the same employer for area activities. The eligibility for employers in LARZ expired January 1, 1998. Eligibility for employers in a LAMBRA expires January 1, 2003.

Taxes Paid by Enterprise Zone Employees. Enterprise Zone employees can receive an income tax credit of 5 percent of their "quali-

fied wages," up to a maximum of $525. The credit is reduced by 9 cents for each $1 in wages in excess of "qualified wages," as defined in the federal Internal Revenue Code, Section 3306(b). The credit is nonrefundable, and unused portions may not be carried forward.

Sales Tax on Machinery. An employer can receive an income tax credit for the amount of sales and use taxes paid on the purchase of machinery or parts used for specific purposes in Enterprise Zones, LAMBRA, LARZ, and for certain activities, within Targeted Tax Areas. The credit, together with amounts claimed under the wages credit (discussed above), is limited to the amount of income tax attributable to the incentive area. The credit is nonrefundable, but unused portions may be carried forward into succeeding tax years.

RATIONALE

These programs are intended to provide incentives for stimulating employment and business activity in economically depressed areas of the state. These areas typically either have higher costs associated with conducting economic activity or are perceived as being high-cost, low-productivity areas. The credits represent an attempt to reduce costs and make the areas more attractive for undertaking investments and conducting economic activity.

COMMENTS

These programs were initially established in 1984 by the state's Enterprise Zone Act and Employment and Economic Incentive Act, and amended in 1985. The Employment and Economic Incentives Act was repealed and essentially replaced by the Enterprise Zone Act of 1996. The LARZ, LAMBRA, Targeted Tax Areas, and Manufacturing Enhancement Areas were added later as qualifying for certain tax credits under these programs.

Pursuant to Chapter 323, Statutes of 1998 (AB 2798, Machado), the credits available under these programs were expanded and enhanced. For additional related information, see comments regarding the effectiveness of tax incentives for Enterprise Zones and related areas discussed under the program "Income From Investments in Economically Depressed Areas."

Credit (Activity Based):

INCREASED RESEARCH AND DEVELOPMENT EXPENSES

Program Characteristics	
Tax Type:	Personal Income Tax (PIT). Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 17052.12 and 23609, which partially conform to Internal Revenue Code Section 41.

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT	BCT
1996-97	$10	$270
1997-98	11	330
1998-99	12	350

DESCRIPTION

This program allows taxpayers to claim a tax credit for a portion of certain additional increments to their research and development (R&D) expenses. The credit may be applied to "qualified" research conducted either "in-house" or by contract. Qualified research is defined as research that is: (1) technological in nature; (2) intended to be useful in the development of a new or improved product, service, computer software, technique, formula, or invention of the taxpayer; (3) held for sale, lease, or license, or used by the taxpayer in a trade or business; and (4) performed in California.

Beginning in 1997, the R&D credit is equal to 11 percent of the taxpayer's *additional* qualified research expenses for the tax year, over a specified percentage of the taxpayer's average annual gross receipts for the four preceding taxable years. For BCT taxpayers, an additional credit equal to 24 percent of the taxpayer's basic (defined as university) research is availaable. To the extent that the credit exceeds the taxpayer's net tax liability in the taxable year, the excess may be carried forward and used to reduce tax liabilities in subsequent years.

Under certain conditions, a specified formula may be used to calculate an alternative incremental credit. This alternative incremental credit was increased pursuant to Chapter 323, Statutes of 1998 (SB 2798, Machado).

RATIONALE

This program provides an incentive for taxpayers to invest in R&D activities by reducing the after-tax cost of making such investments. The underlying rationale is that if such incentives were not available, industry would "underinvest" in R&D activities from a social point of view.

DISTRIBUTION OF BENEFITS

The accompanying table (see next page) shows the distribution of benefits from the program by industry, based on number of returns and the amount of tax benefits received. Almost 60 percent of the returns claiming the credit are from electronics firms and other manufacturing enterprises. The dollar amount of tax benefits are even more heavily weighted towards these types of industries, with over two-thirds of the total benefits going to these two industry groups. Electric and electronic equipment industries alone claimed almost one-half of the credits.

Increased Research and Development Expenses Tax Credit		
1998 Income Year		
	Percent of	
Industry Type	Total Taxpayers Benefitting	Total Amount Claimed
Electrical and Electronics Equipment	26.8%	46.6%
Chemicals and Allied Products	3.9	10.0
Food and Kindred Products	0.9	0.3
Other Manufacturing	29.2	20.9
Other	39.2	22.3

COMMENTS

According to the Research Institute of America, over one-third of all states offer a tax credit to businesses for R&D conducted within their state. The amount of the tax credit a business can claim varies from state to state largely due to the differences in the base period used and the percent of expenses applicable. The federal government also provides a tax credit for R&D expenditures, which differs in several respects from the California credit.

Supporters of R&D credits argue that the subsidy they provide is needed to encourage increased investment by private industry in emerging areas of technological change and development—investment which would not occur in the absence of the credit. A number of economists support this view.

Some opponents of the credit, however, argue that it does little to spur additional investment, and that its costs far outweigh the benefits to society. Other critics of R&D credits argue that while underinvestment in R&D would occur in the absence of intervention programs, tax credits are an inappropriate *mechanism* through which to address the problem. Some, for example, put forth a direct R&D subsidy as an alternative approach.

Evidence regarding the effectiveness of the R&D credit remains ambiguous. Although there do not appear to be any studies that have analyzed the effectiveness of California's R&D tax credit, numerous analyses of the federal credit have been conducted. The U.S. General Accounting Office (GAO), for example, reports that some additional research spending was stimulated by the tax credit, with most of the benefits going to large manufacturing corporations. However, GAO also reported that in 1992, 79 percent of corporations earning R&D credits had accumulated more general business tax credits than could be used. Thus, the marginal incentive provided by additional R&D tax credits was reduced (see U.S. GAO, *Tax Policy: Additional Information on the Research Tax Credit*, 1995). Some studies regarding the effectiveness of the credit found it to have a relatively minor impact on R&D spending by U.S. corporations (see, for example, Eisner, Albert and Sullivan, *The New Incremental Tax Credit for R&D: Incentive or Disincentive?,* National Tax Journal, V. 37, 1984; and Karier, *Closing the R&D Gap: Evaluating the Sources of R&D Spending*, Jerome Levy Economics Institute, Working Paper #22, 1995).

The GAO's recent review of eight separate studies regarding the R&D credit indicates that the effectiveness of the credit is still open to debate. While four of the reviewed studies linked the R&D credit to additional research spending that exceeded the cost of the credit, the remaining four did not support this claim or were inconclusive. The GAO determined that, due to data limitations and methodological issues, available studies are inadequate to the task measuring the effectiveness of the credit (see U.S. GAO, *Tax Policy and Administration: Review of the Effectiveness of the Research Tax Credit*, 1996).

Credit (Activity Based):

EMPLOYER-PROVIDED CHILD CARE EXPENSES

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).* *Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17052.17, 17052.18, 23617, and 23617.5.*

Estimated Revenue Reduction		
(In Millions)		
Fiscal Year	***PIT***	***BCT***
1996-97	*$1*	*$5*
1997-98	*1*	*5*
1998-99	*Minor*	*3*

DESCRIPTION

The PIT and BCT provide employers several tax credits for child care assistance programs. These tax credit programs allow employers to deduct the costs of certain contributions toward employee child care expenses incurred between January 1, 1988 and January 1, 2003. Specifically, employers may deduct:

- Thirty percent of the startup costs of establishing a child care program, the costs of constructing a child care facility, and/or the costs of child care referral services, up to $50,000 per tax year.
- Thirty percent of the cost of contributions to a qualified child care plan. A qualified care plan may include onsite or offsite child care centers, in-home care, and specialized centers which provide care for children with short-term illnesses. Qualifying contributions may not exceed $360 per qualified dependent per tax year.

In order to qualify for the tax credit, these costs must be associated with programs primarily used by children of the taxpayer's employees who are under the age of 15. To the extent that the credit amounts exceed a taxpayer's net tax liability in the year the expenses are incurred, they may be carried forward and used to offset the taxpayer's liability in future years, but not by more than $50,000 in any one tax year.

RATIONALE

This program is intended to give employers a financial incentive to provide for the child care needs of their employees. It does this by reducing the after-tax cost of making these provisions.

COMMENTS

Employers must reduce their *basis cost* (which is used for purposes of determining capital gains and losses when property eventually is sold) in child care facilities on which a tax credit is claimed, by the amount of the credit claimed for those facilities. A taxpayer can elect to take depreciation in lieu of claiming the credit. Pursuant to Chapter 323, Statutes of 1998 (AB 2798, Machado), this program was extended from January 1, 1998 to January 1, 2003.

Credit (Activity Based):

LOW-INCOME RENTAL HOUSING EXPENSES

Program Characteristics

Tax Type:	Personal Income Tax (PIT). Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 17058 and 23610.5, which partially conform to Internal Revenue Code Section 42.

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT	BCT
1996-97	$6	$23
1997-98	6	24
1998-99	6	24

DESCRIPTION

This program provides a tax credit for investors for a portion of the costs of investing in low-income rental housing projects. The amount of the credit depends on the amount needed by the investor in order to make the project economically feasible. This amount is determined by the California Tax Credit Allocation Committee, which reviews program applications and allocates credits based on certain previously established legislative priorities.

Generally, the percentage of costs for which credits may be claimed is based on federal guidelines. The maximum amount the committee may award to a project is designed so that the present value of four annual credit payments generally equals 30 percent of an investor's qualified basis in the low-income housing units. "Qualified basis" is roughly equal to the acquisition, construction, and/or rehabilitation costs of the units. In exchange for the tax credits, the investor must commit to renting a specified percentage of units to low-income individuals based on one of the following options:

- Renting 20 percent of the units to individuals whose income is no more than 50 percent of area median income.
- Renting 40 percent of the units to individuals whose income is no more than 60 percent of area median income.

The rent on these program units based on either option may not exceed 30 percent of these specified income limits.

RATIONALE

This tax credit program is intended to increase the number of affordable rental housing units available to low-income households in California, by reducing the after-tax costs to developers and investors who produce and invest in such units.

COMMENTS

This program complements a federal tax credit program which also works to promote the development of low-income housing. The maximum federal tax credit that can be awarded is generally equal to 70 percent (on a present-value basis) of a taxpayer's qualified basis in the project, spread over a ten-year period. A project that receives the maximum in both state and federal credits receives 100 percent of the taxpayer's qualified basis over a 10-year period. Both the state and federal programs are administered by the California Tax Credit Allocation Committee.

The state program is authorized as long as the federal program continues in existence. California requires that the compliance period over which the program requirements noted earlier must be adhered to extend for 30 consecutive years, rather than the 15-year federal period.

Chapter 1222, Statutes of 1993 (AB 1438, Caldera), expanded this credit to allow insurance companies to qualify. Specifically, insurance companies are allowed a share of the annual credit allocated for investments in low-income housing and can use the credit to offset their gross premiums tax.

Credit (Activity Based):

JOINT CUSTODY HEAD OF HOUSEHOLD

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Section 17054.5.*

Estimated Revenue Reduction	
(In Millions)	
Fiscal Year	***PIT***
1996-97	*NA*
1997-98	*NA*
1998-99	*NA*

DESCRIPTION

This program allows a tax credit for divorced or separated individuals who *do* bear significant costs in order to maintain a home for a dependent for part of the year, but do *not* provide the principal residence for a dependent (and, therefore, do not qualify for the more-advantageous "head-of-household" filing status).

Specifically, the program allows a tax credit equal to the lesser of (1) 30 percent of a taxpayer's net tax or (2) a maximum amount determined annually ($281 in 1998). The program is available to divorced or separated taxpayers who (1) live apart from a spouse for at least six months prior to the end of the tax year, and (2) provide for at least one-half of the cost of maintaining the principal residence of a dependent for at least 146 days but not more than 219 days of the tax year. (A taxpayer who maintains the principal residence of a dependent for more than 219 days of the tax year qualifies for the more-advantageous head-of-household filing status.)

RATIONALE

This program is intended to provide tax relief to taxpayers who are single, or married and living apart, and who care for dependents such as children for a significant portion of the tax year. The program's rationale reflects the view that, in the case of taxpayers who have to maintain households in order to care for dependents, their economic burdens are greater than those of individuals with no such responsibilities.

COMMENTS

Federal law defining "head of household" was incorporated into California law by reference for post-1986 tax years. In order for the head-of-household filing status to be claimed, the household must be the principal residence of the qualifying dependent for more than 219 days of the year. Chapter 1537, Statutes of 1982 (AB 2520, Sher) created a special "joint custody" head-of-household filing status with its own personal exemption credits and tax rates. This separate filing status was replaced with this tax credit by Chapter 1138, Statutes of 1987 (AB 53, Klehs).

Credit (Activity Based):

SALMON AND STEELHEAD TROUT HABITAT RESTORATION

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).* *Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17053.66 and 23666.*

Estimated Revenue Reduction		
(In Millions)		
Fiscal Year	***PIT***	***BCT***
1996-97	*Minor*	*Minor*
1997-98	*Minor*	*Minor*
1998-99	*Minor*	*Minor*

DESCRIPTION

This program, which sunsets on December 1, 2000, provides a tax credit equal to the lesser of (1) 10 percent of the qualified costs paid or incurred for salmon or steelhead trout habitat restoration, up to $50,000 per taxpayer, or (2) the amount certified by the California Department of Fish and Game (DFG). The credit may be used to offset tax liabilities during years in which the expenses are incurred, and any unused credit may be used to offset tax liabilities in future years.

To be able to claim the credit, the taxpayer must apply to the DFG. The department is responsible for certifying that the taxpayer's project has met specified criteria and for authorizing the actual amount of credit that the taxpayer may claim. The project must meet the following criteria: (1) meet the objectives of the Salmon, Steelhead Trout, and Anadromous Fisheries Program Act and contribute to the increase in production of salmon and trout by improving certain habitat conditions; (2) provide employment to unemployed fishing or forestry industry persons in counties with a higher-than-average annual rate of unemployment as specified by the Employment Development Department; and (3) undertake work that does not include construction of office, storage facilities, garages, maintenance buildings, hatchery facilities, permanent surface roadways, bridges, wells, or pumping equipment. The amount of credit allowable must be reduced by the amount of any grant or cost-sharing payment for the project made by a public entity.

RATIONALE

This program provides an incentive for taxpayers to undertake projects to restore the habitats of salmon and steelhead trout. It does this by offsetting a portion of the costs incurred through a credit that is applied towards the taxpayer's tax liability.

Credit (Activity Based):

MANUFACTURERS' INVESTMENT TAX CREDIT

Program Characteristics	
Tax Type:	Personal Income Tax (PIT). Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 17053.49 and 23649.

Estimated Revenue Reduction (In Millions)		
Fiscal Year	**PIT**	**BCT**
1996-97	$34	$390
1997-98	34	395
1998-99	34	390

DESCRIPTION

This program provides a tax credit intended to encourage manufacturing activity and investment in the state. It provides *qualified* taxpayers an income tax credit equal to 6 percent of the *qualified* costs incurred for construction, acquisition, or lease of *qualified* property that is placed in service in California.

- "Qualified taxpayers" are persons engaged in specified businesses as described in the Standard Industrial Classification (SIC) Manual.
- "Qualified costs" include (1) amounts on which the taxpayer paid sales and use tax and that are considered capital acquisitions, and (2) the value of any capitalized labor costs that are directly related to the construction or modification of qualified property.
- "Qualified property" means tangible personal property that is depreciable or computer software used primarily in manufacturing, research, pollution control, recycling, or in maintaining, repairing, measuring, or testing property used in such activities. It also includes, for certain activities, special purpose buildings and foundations that are primarily used in connection with manufacturing, refining, processing, fabricating, or research and storage.

If the property is removed from California, the credit is "recaptured" by adding the credit amount received back on to the appropriate year's net tax liability of the taxpayer. In general, unused credits may be carried forward for up to eight years to offset tax liabilities. In the case of qualified small businesses, the carryforward period is ten years.

RATIONALE

This program provides an incentive for qualified taxpayers to expand their investments in manufacturing and research property in California. It does this by offsetting a portion of the costs incurred through a credit that is applied towards their tax liabilities.

DISTRIBUTION OF BENEFITS

The accompanying table (see next page) shows the distribution of benefits of the program for various industries, based on number of returns and by total amount of tax benefits involved. Over one-half of the total dollar amount of benefits of the program goes to electronics and petroleum refining firms. Another one-quarter accrues to other types of manufacturing enterprises.

Manufacturers' Investment Tax Credit

1998 Income Year

Industry Type	Percent of Total Taxpayers Benefitting	Percent of Total Amount Claimed
Electrical and Electronics Equipment	13.2%	26.9%
Petroleum Refining	0.7	25.1
Chemicals and Allied Products	4.5	5.6
Food and Kindred Products	7.6	7.4
Other Manufacturing	56.5	27.4
Other	17.6	7.4

COMMENTS

A *sales and use tax* exemption of 5 percent is available for new businesses that first commence activity in California after 1993 and have not been in existence for more than three years. However, if a taxpayer claims this program's *income* tax credit, then the taxpayer *cannot* claim the sales and use tax exemption.

This credit essentially reduces the cost of capital acquisitions, and consequently could result in a relative shift away from labor and towards capital. This could be coupled with increased labor demand as a result of overall reduced manufacturing costs, and an increase in production.

Pursuant to Chapter 323, Statutes of 1998 (AB 2798, Machado), the credit was expanded to include taxpayers engaged in software development, computer programming, and computer integrated systems design.

Credit (Activity Based):

ENHANCED RECOVERY COSTS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT). Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17052.8 and 23604, which generally conform to Internal Revenue Code Section 43.*

Estimated Revenue Reduction		
(In Millions)		
Fiscal Year	**PIT**	**BCT**
1996-97	Minor	Minor
1997-98	Minor	$2
1998-99	Minor	2

DESCRIPTION

This program provides a tax credit for 5 percent of the qualified costs associated with “enhanced recovery” of oil and gas (such as pumping heated liquids or gasses into a well to enhance the flow of these materials). This credit applies only to nonvertically integrated producers for projects located within California. Unused credits may be used to offset tax liabilities in the future, for up to 15 years. If the taxpayer’s costs qualify for another credit, the taxpayer must make an election between credits. No tax deduction is allowed for costs for which the credit is allowed.

RATIONALE

This program provides an incentive for businesses to use more efficient oil and gas recovery technologies by partially offsetting the associated costs.

COMMENTS

This program conforms with a federally enhanced oil recovery tax credit program. The federal program provides a tax credit for 15 percent of the qualified costs incurred.

Credit (Activity Based):

FARMWORKER HOUSING COSTS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).* *Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17053.14, 23608.2, and 23608.3.*

Estimated Revenue Reduction		
(In Millions)		
Fiscal Year	***PIT***	***BCT***
1996-97	*Minor*	*Minor*
1997-98	*Minor*	*Minor*
1998-99	*Minor*	*Minor*

DESCRIPTION

This program provides a tax credit in the amount of the lesser of: (1) 50 percent of the costs associated with building, repairing, or donating farmworker housing; or (2) the amount certified by the California Tax Credit Allocation Committee. To claim the credit, the taxpayer must enter into an agreement with the committee to build or donate housing meeting specified criteria, with the credit available only during the year when the housing is completed and occupied.

A tax credit is also available to lenders who provide low-interest loans for farmworker housing. It is equal to half of the difference between market interest rates and the rates actually charged. California requires a compliance period of 30 years to be eligible for the credit.

RATIONALE

This program provides a tax incentive for taxpayers to provide suitable housing for farmworkers. The rationale is that the incentive to farm owners and others will stimulate the provision and construction of suitable housing for farmworkers.

Credit (Activity Based):

RICE STRAW

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).* *Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17052.10 and 23610.*

Estimated Revenue Reduction (In Millions)		
Fiscal Year	***PIT***	***BCT***
1996-97	*Minor*	*Minor*
1997-98	*Minor*	*Minor*
1998-99	*Minor*	*Minor*

DESCRIPTION

Upon certification by the California Department of Food and Agriculture, this program provides a tax credit in the amount of $15 per ton of rice straw that is grown in California and purchased by the taxpayer. The taxpayer must be an "end user" of rice straw; that is, the taxpayer must use the rice straw for processing, generation of energy, manufacturing, export, prevention of erosion, or for any other purpose exclusive of open burning.

Under the program, the department issues taxpayers a certificate specifying the amount of any tax credit allocated. Up to $400,000 per year in total tax credits may be allocated on a first-come, first-served basis. Any claimed but unused credits may be carried forward by taxpayers to offset their tax liabilities in future years, for up to ten years.

RATIONALE

The program is aimed at reducing the open burning of rice straw by farmers, thereby reducing the air pollution impacts of such burning. It does so by providing an incentive for taxpayers to purchase rice straw for other purposes. The rationale is that rice straw can be put to more productive uses than simply open burning; however, it often is more costly for the user to choose such other options. This program is intended to partially offset the costs of purchasing the rice straw so that taxpayers will be encouraged to use rice straw in a more efficient manner.

Credit (Activity Based):

DISABLED ACCESS EXPENDITURES

Program Characteristics	
Tax Type:	Personal Income Tax (PIT). Bank and Corporation Tax (BCT).
Authorization:	California Revenue and Taxation Code Sections 17053.42 and 23642, which generally conform to Internal Revenue Code Section 44.

Estimated Revenue Reduction (In Millions)		
Fiscal Year	**PIT**	**BCT**
1996-97	Minor	Minor
1997-98	Minor	Minor
1998-99	Minor	Minor

DESCRIPTION

This program provides a tax credit for 50 percent of up to $250 of qualified expenditures to eligible small businesses that provide access to disabled individuals. Thus, this program allows a California credit up to a maximum of $125. To qualify for the credit, the business must (1) have earned less than $1 million in gross receipts in the previous year, and (2) employ not more than 30 full-time employees.

Qualified expenditures include those costs associated with complying with the Americans With Disabilities Act of 1990. This includes removing physical barriers that block entrance to a business and acquiring equipment to aid in servicing individuals with specified disabilities, such as hearing and vision impairments. Any unused credit may be carried forward to offset tax liabilities in future years.

RATIONALE

This program complements an already-established federal tax credit. It also provides an incentive to qualified businesses to make certain "minor" improvements that may not exceed the threshold to qualify for the federal credit.

COMMENTS

The federal government provides a tax credit for 50 percent of qualified expenditures exceeding $250 and up to $10,250. This program covers the initial $250 of qualified expenditures.

Credit (Activity Based):

TRANSPORTATION OF DONATED AGRICULTURAL PRODUCTS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).* *Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17053.12 and 23608.*

Estimated Revenue Reduction		
(In Millions)		
Fiscal Year	***PIT***	***BCT***
1996-97	*Minor*	*Minor*
1997-98	*Minor*	*Minor*
1998-99	*Minor*	*Minor*

DESCRIPTION

This program provides a tax credit for 50 percent of transportation costs paid or incurred by a taxpayer that are related to the transportation of donated agricultural products to a nonprofit, charitable organization. Upon receipt, the charitable organization furnishes the donor with a certificate specifying the transportation of donated agricultural products, including the type and amount of products donated and the distance transported. Any unused tax credit may be carried forward to offset tax liabilities in future years.

RATIONALE

This program provides an incentive for taxpayers to donate or incur the costs for transporting agricultural products to charitable organizations. The underlying rationale is that charitable organizations are providing a socially beneficial service by distributing agricultural products to needy individuals, and that this service is worthy of indirect state support. By partially offsetting the costs of transporting the agricultural products, the program encourages more taxpayers to donate or incur the costs of transporting these products. Thus, more agricultural products may reach charitable organizations than otherwise would without the incentive.

Credit (Activity Based):

CHILD ADOPTION EXPENSES

Program Characteristics	
Tax Type:	Personal Income Tax (PIT).
Authorization:	California Revenue and Taxation Code Section 17052.25.

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT
1996-97	$1
1997-98	1
1998-99	1

DESCRIPTION

This program provides a tax credit equal to 50 percent of the qualified costs of an adoption of a minor child who is a legal resident or citizen of the United States and was in the custody of a public adoption agency of this state. Qualified costs include fees for required services, travel and related expenses for the adoptive family that are directly related to the adoption process, and medical fees and expenses not reimbursed by insurance that are directly related to the adoption. The tax credit may offset tax liabilities up to $2,500 per child in the year that the adoption papers are ordered. Any unused credit may be carried forward to offset tax liabilities in future years.

RATIONALE

This program provides tax relief to families choosing to adopt a child. The underlying rationale is that adoption provides a socially beneficial service which is worthy of public financial support.

Special Filing Status:

SUBCHAPTER S CORPORATIONS

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).* *Bank and Corporation Tax (BCT).*
Authorization:	*California Revenue and Taxation Code Sections 17087.5, 18006, and 23800 through 23813, which partially conform to Internal Revenue Code Sections 1361 through 1379.*

Estimated Revenue Effect

(In Millions)

Fiscal Year	*PIT*	*BCT*
1996-97	*+$217*	*$1,185*
1997-98	*+236*	*1,175*
1998-99	*+255*	*1,235*

DESCRIPTION

This program allows eligible small business corporations to elect Subchapter S corporation status for purposes of determining their tax liability. The so-called "S" corporations pay taxes on corporate income at a reduced rate of 1.5 percent, except for financial institutions, which are subject to a 3.5 percent rate. The S corporations are *not* subject to the Alternative Minimum Tax (AMT) but *are* subject to the applicable corporate minimum tax. Individual shareholders of an S corporation pay personal income taxes on their pro rata share of corporate income.

In contrast to S corporations, a regular "C" corporation pays taxes on its corporate income at a rate of 8.84 percent (or 10.84 percent for financial institutions), for income earned beginning on or after January 1, 1996. Corporate shareholders in C corporations pay taxes on corporate earnings only to the extent that such earnings are paid out of dividends.

In order to be eligible to elect S corporation status, a corporation must have (1) a valid federal S election in effect, (2) fewer than 75 shareholders, and (3) only one class of stock. Those corporations which meet these criteria and make a federal S election are deemed to have made an S election for state purposes as well. However, a corporation may make a separate state election to be treated as a C corporation for state tax purposes, even if a federal S election has been made.

RATIONALE

This program is intended to provide tax relief to small corporations while still allowing them to take advantage of the limited liability aspect of corporate status. Generally, businesses that make an S election pay less in taxes than they would as C corporations.

DISTRIBUTION OF BENEFITS

The benefits of the Subchapter S special filing status accrue largely to small-to-mid-sized companies, as shown in Figure 1 (see next page). Almost three-quarters of the corporate taxpayers benefitting from the program are enterprises with receipts of less than $1 million per year. In terms of total benefits received, over two-thirds of benefits go to enterprises with receipts of $50 million or less. Figure 2 (see next page) indicates the distribution of benefits of Subchapter S filing status by type of enterprise. The industry

sector that benefits the most in dollar terms from the Subchapter S filing status is manufacturing, which accounts for 36 percent of the total benefits. (The distribution of benefits is based only on the effects of the program on BCT revenues and does not include any offset due to increases in PIT revenues.)

Figure 1

Subchapter S Corporations Tax Benefits by Receipt

1998 Income Year

	Percent of	
Total Receipts (In Millions)	Total Taxpayers Benefitting	Total Amount Claimed
Under $1	74.0%	7.3%
1–10	20.7	32.7
10–50	4.6	28.6
50–100	0.4	10.5
100–500	0.3	9.7
500–1,000	0.1	10.4
Over 1,000	0.1	0.8

Figure 2

Subchapter S Corporations Tax Benefits by Industry

1998 Income Year

	Percent of		
Industry Type	Gross State Product	Total Taxpayers Benefitting	Total Amount Claimed
Agriculture, Forestry & Fishery	3.0%	2.4%	3.0%
Construction	3.8	7.4	4.4
Manufacturing	15.9	10.5	35.9
Services	25.1	38.8	27.1
Trade	18.2	20.3	18.0
Finance, Real Estate & Insurance	25.9	16.9	8.3
Utilities & Transportation	8.2	3.7	3.4

COMMENTS

The revenue increases for PIT result from two factors: (1) unlike C corporation income, all operating income from S corporation earnings is passed through to shareholders and taxed as personal income; and (2) nonresident shareholders must pay California personal income taxes on earnings. These revenue increases may be partially offset by the pass-through of losses to shareholders, which can be deducted from income.

Under federal law, an election of S corporation status completely eliminates any tax liability of the corporation itself. All income and expenses are passed through to shareholders, and there is no entity-level tax imposed. Net income is taxed on a pro rata basis as if it were received as individual income.

According to data from the Franchise Tax Board, there were 118,514 S corporations in California in 1996, with a reported net income of $12.5 billion and tax liabilities of $282 million.

Federal conformity legislation in the form of Chapter 612, Statutes of 1997 (SB 1233, Lockyer), and Chapter 610, Statutes of 1997 (SB 5, Lockyer) contained several provisions affecting S corporations. In particular, scheduled increases in the tax rate were eliminated and the 1.5 percent entity-level tax rate was retained. In addition, the number of allowable shareholders was expanded from 35 to 75. The legislation also liberalized shareholder eligibility, allowed various financial institutions to be S corporations, and permitted S corporations to have wholly owned subsidiaries.

Special Filing Status:

HEAD-OF-HOUSEHOLD AND SURVIVING SPOUSE

Program Characteristics	
Tax Type:	*Personal Income Tax (PIT).*
Authorization:	*California Revenue and Taxation Code Sections 17042, 17046, and 17054, which partially conform to Internal Revenue Code Sections 2, 151, and 152.*

Estimated Revenue Reduction

(In Millions)

Fiscal Year	PIT
1996-97	NA
1997-98	NA
1998-99	NA

DESCRIPTION

This program allows taxpayers who care for dependents to qualify for lower tax rates than are available to single persons or to married persons filing separate returns. This program is intended to provide tax relief to heads-of-households who are single, or married but living apart, and surviving spouses. Surviving spouses qualify for a larger personal exemption in addition to the lower tax rates.

RATIONALE

The program's rationale reflects the view that taxpayers who have to maintain households in order to care for dependents have greater economic burdens than do individuals with no such responsibilities. In addition, the program reflects the view that tax relief may be needed by many surviving spouses in order to be able to maintain their economic status.

COMMENTS

Federal law definitions for the head-of-household and surviving-spouse filing statuses were incorporated into California law by reference for post-1986 tax years. In order to claim the head-of-household filing status, a taxpayer must provide the principal home of the qualifying dependent for over one-half of the year. In addition, the taxpayer must pay more than one-half of the cost of maintaining that household. A surviving spouse is a taxpayer whose spouse died within two years prior to the taxable year involved, who cares for a dependent child, and has not remarried.

Chapter 846, Statutes of 1990 (AB 3086, Klehs), provides that taxpayers with a *non*dependent relative living in the home qualify for head-of-household filing status. For example, if a single custodial parent has moved into the home of her widowed father, the father would qualify as a head-of-household. Although the child is the custodial parent's dependent, the grandfather qualifies to claim the head-of-household filing status because he provides more than one-half of the cost of maintaining the home.