April 30, 2003

Hon. Bill Lockyer
Attorney General
1300 I Street, 17th Floor
Sacramento, California 95814

Attention: Ms. Tricia Knight
Initiative Coordinator

Dear Attorney General Lockyer:

Pursuant to Elections Code Section 9005, we have reviewed the statutory initiative relating to certain provisions of the California personal income tax (PIT) (File No. SA2003RF0010). This measure would allow certain PIT taxpayers earning less than a specified amount to benefit from a larger standard deduction than is currently available and have their resulting taxable income taxed at a new rate of 2.5 percent. The measure would result in a reduction in revenues that are raised from the PIT.

Background Regarding the Initiative

California levies a PIT on all income earned in the state, at rates ranging from 1 percent to 9.3 percent depending upon the amount of taxable income. Taxpayers may take the standard deduction or claim itemized deductions in order to reduce the amount of their income subject to taxation. For tax year 2002, the standard deduction is $6,008 for married-filing-joint taxpayers and $3,004 for single taxpayers. For taxpayers who instead choose to itemize their deductions (because this would result in additional tax savings), various specific deductions may be claimed to reduce the amount of tax that the taxpayer owes.

Provisions of the Initiative

Basic Provisions. The initiative amends the California Revenue and Taxation Code, providing for a separate filing option for: (1) married-filing-joint taxpayers with an annual adjusted gross income (AGI) of $100,000 or less and (2) single taxpayers with an annual AGI of $50,000 or less. In addition, in order to file under this program, taxpayers' incomes would be limited solely to wages, salaries, tips, dividends, interest, and pensions.

Taxpayers meeting these requirements could take a standard deduction equal to California's hourly minimum wage (currently $6.75) multiplied by 2,080 for married-filing-joint taxpayers, and by 1,040 for single taxpayers. (Thus, for the 2002 tax year, the available standard deduction for married and single taxpayers would be $14,040 and $7,020, respectively. These amounts are well above current levels.) Taxable income for taxpayers filing under this section of the tax code would have their taxable incomes taxed at the new rate of 2.5 percent. Taxpayers would still have the option, however, to file under existing tax provisions if this worked to their benefit.

Related Issues. There is some ambiguity as to whether taxpayers filing under this section would be allowed to claim tax credits. Our fiscal estimate below assumes that certain special credits would be allowed, but exemption credits (such as the personal exemption credit and the dependent exemption credit) would not be allowed. For purposes of our estimate, we have assumed an effective date for the law change of January 1, 2004.

We also note that, while some taxpayers would realize state tax savings under the provisions of the initiative, to the extent that these taxpayers itemize their deductions for federal income tax purposes, a portion of these state savings would be offset by increases in federal taxes due to a decline in the deductions claimed for state PIT payments.

Fiscal Effects of the Initiative

Revenue Effects. Based on information provided by the California Franchise Tax Board (FTB), and assuming all taxpayers who would pay a lesser amount in taxes under the proposal chose to do so, we estimate that the reduction in state PIT revenues would be approximately $900 million in 2004-05, with revenue losses of roughly $700 million annually thereafter. In the initial year of the tax program, approximately 1.7 million taxpayers could benefit from the tax change.

Administrative Costs. The FTB would experience minor ongoing cost savings beginning in 2004-05 associated with processing and audit activities, due to more taxpayers filing these simpler standard-deduction returns. These savings would be partially offset, at least initially, by increased costs for revising existing regulations, tax forms, and certain processing activities.

Summary of Fiscal Effects

The measure would have the following major fiscal effects:

- Reduction in state income tax revenues of approximately $900 million in 2004-05 and $700 million annually thereafter.

Sincerely,

Elizabeth G. Hill
Legislative Analyst

Steve Peace
Director of Finance