

December 17, 2007

Hon. Edmund G. Brown Jr.  
Attorney General  
1300 I Street, 17<sup>th</sup> Floor  
Sacramento, California 95814

Attention: Ms. Krystal Paris  
Initiative Coordinator

Dear Attorney General Brown:

Pursuant to Elections Code Section 9005, we have reviewed the statutory initiative relating to state taxation (A.G. File No. 07-0082, Amdt. #1-NS).

## **BACKGROUND**

The state levies a personal income tax (PIT) on the California income of individuals and noncorporate businesses, such as sole proprietors and partnerships. The rates of the tax range from 1 percent to 9.3 percent, depending upon the taxpayer's income level. An extra 1 percent tax is levied on the portion of taxpayers' incomes greater than \$1 million. The PIT allows various deductions from income and credits against any tax owed.

## **PROVISIONS OF THE INITIATIVE**

This measure contains the following main provisions:

*Establishes a Wealth Tax.* The measure institutes a state wealth tax levied on the net assets of individuals with values in excess of about \$40 million as of January 1, 2008. The wealth tax would be based on the tax rates established by the federal estate tax, which has a progressive structure and whose top rate in calendar year 2007 is 45 percent. However, the measure specifies that the tax rate applied must not be less than 45 percent, meaning that this rate would most likely apply to estates of all sizes. It appears that the wealth tax would be levied on taxpayers in the state on a one-time basis, with revenues to be deposited in the newly created Environmental Superfund in 2009-10 and 2010-11. The monies in this fund would be used to acquire a majority interest in outstanding voting common stock of various petroleum and automotive companies as well as for other environmental protection-related purposes.

*Taxes People When They Die or Leave the State.* The measure imposes a new tax on the income of specified individuals when they die or move out of California. It defines this income to include both income that would ordinarily be reported and any gains in asset values. Individuals with incomes greater than \$5 million would be subject to the tax, and associated revenues would be deposited in the Environmental Superfund. Whether these provisions would impair interstate commerce, and thus violate the U.S. Constitution, might be subject to court review.

*Makes Changes to the PIT.* The measure imposes an additional tax under PIT for joint-return taxpayers equal to 17.5 percent of their total taxable incomes if greater than \$250,000, with an additional tax of 17.5 percent (for a 35 percent total additional tax) on incomes greater than \$500,000. For single taxpayers, these additional taxes would be applied to incomes greater than \$150,000 and \$350,000, respectively. In addition, the measure establishes several new tax programs that would reduce PIT revenues, including refundable tax credits for: (1) particular designated organizations, (2) the costs of purchasing health insurance for certain individuals, (3) income earned by teachers, (4) higher education tuition and fees, and (5) property tax payments. The first \$7.5 billion of net annual PIT revenue from these changes would be allocated to the General Fund, with the remaining additional revenues directed to the Environmental Superfund.

## **FISCAL EFFECTS OF THE INITIATIVE**

This measure would make major changes in the state and local tax system. Some of these changes would generate very significant behavioral and economic responses from taxpayers. For example, the taxes on people leaving the state and the additional PIT rates could have a significant negative impact on future economic activity and revenues to the state and local governments. Given factors such as these, the fiscal estimates provided below are subject to considerable uncertainty.

### **Impact From New Taxes**

*One-Time Increase From the Wealth Tax.* The measure would result in a one-time increase in state revenues (realized in 2008-09 and 2009-10) as a result of the establishment of the wealth tax. The combined increase for both years could be in the range of the low hundreds of billions of dollars. The one-time revenues generated by the wealth tax would be deposited in the Environmental Superfund. This estimate assumes no behavioral changes on the part of taxpayers. These changes and their impacts could be very significant, in which case the estimates above would be overstated.

*Ongoing Increase From Tax on People Dying or Leaving the State.* The revenue gain from the tax upon those dying or leaving the state is unknown, and would depend upon taxpayer behavior, but would potentially result in additional revenues in the bil-

lions of dollars annually. These revenues also would be deposited in the Environmental Superfund. This effect assumes no behavioral changes on the part of taxpayers. These changes and their impacts could be very significant, in which case the estimates above would be overstated.

### **Impact of PIT Changes**

*Ongoing Revenue Impact.* The revenue gain from changes to PIT tax rates would—absent behavioral impacts—result in additional revenues in the range of the high tens of billions of dollars annually. Offsetting these additional revenues would be reductions associated with various tax programs. The largest of these reductions involve the proposed refundable health insurance tax credit, teacher tax credit, and property tax credit. These and other provisions would reduce state revenues (or result in increased expenditures in the case of refundable credits in excess of tax liabilities) in the tens of billions of dollars annually. The net increase of all of the ongoing PIT changes would be potentially in the tens of billions of dollars annually. The first \$7.5 billion of additional revenue would be allocated to the General Fund annually, with any additional revenue above this amount allocated to the Environmental Superfund.

The above estimated ongoing revenue effects assume no behavioral changes on the part of taxpayers. These changes and their impacts could be very significant, in which case the estimates above would be overstated.

### **Other Effects**

*Behavioral Effects.* If significant behavioral effects occur that reduce economic activity in California—such as employment, personal income, and investment decisions—then state and local government revenues would be adversely affected. The magnitude of these potential revenue losses is unknown but potentially in the tens of billions of dollars annually.

*Impact on Proposition 98.* Proposition 98, passed by voters in 1988, provides a minimum annual funding level for schools which is driven by such factors as the growth in state personal income and the level of state General Fund revenues. This initiative specifically exempts the revenues from its new taxes from the provisions of Proposition 98. It appears also to “hold harmless” Proposition 98 from the impacts of the various tax reduction provisions.

### **Summary of Fiscal Effects**

The measure would have the following major fiscal effects:

- One-time increase in state revenues potentially in the low hundreds of billions of dollars from imposition of a wealth tax, and ongoing increase in state revenues potentially in the billions of dollars from imposition of the tax on

certain people dying or leaving the state. This revenue would be allocated to accomplish various goals related to environmental protection.

- Potential annual net increase in personal income tax revenues in the tens of billions of dollars annually from tax rate increases and new tax credits. The first \$7.5 billion annually would be allocated to the state General Fund with additional revenue allocated for environmental protection.
- Unknown state and local revenue reductions—potentially in the tens of billions of dollars annually—due to changes in taxpayer behavior.

Sincerely,

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Elizabeth G. Hill  
Legislative Analyst

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Michael C. Genest  
Director of Finance