May 4, 2009

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

Attention: Ms. Krystal Paris
Initiative Coordinator

Dear Attorney General Brown:

Pursuant to Elections Code Section 9005, we have reviewed the proposed statutory initiative related to the taxation of pension income (A.G. File No. 09-0006).

BACKGROUND

The state levies a personal income tax (PIT) on the California income of individuals who reside in the state. Tax rates 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' income that exceeds $1 million. In general, the state taxes individuals based on income earned while they reside in California. The state currently taxes most pension distributions as ordinary income.

California also levies excise taxes on specific goods. The state, for example, currently imposes excise taxes on the sale of tobacco products and alcohol.

PROPOSAL

The measure would establish new taxes on pension income beginning in 2010. Specifically, the measure would create:

- A PIT surcharge on resident taxpayers who receive more than $40,000 of taxable pension income.
- An excise tax on nonresidents or people who move out of the state whose vested pension benefits from a California employer exceed $50,000 per year.

Surcharge on Resident Pension Income

Under the proposal, a surcharge would be added to the existing tax liability for pension income in excess of $40,000. The surcharge would increase as the amount of pension income increases, so that pension income above $150,000 would receive a tax surcharge of 60 percent. For example, a couple receiving pension income of $160,000 with no other income and only the standard deduction would pay $9,637 in regular taxes (at the 9.3 percent top rate) and a surcharge of $56,750. Figure 1 displays the proposed surcharge schedule.

Figure 1

Proposed Pension Income Surcharge

Taxable Pension Income	Surcharge
Under $40,000	—
$40,000 to $50,000	$5,000 + 20 percent of pension income over $40,000
$50,000 to $75,000	$7,000 + 35 percent of pension income over $50,000
$75,000 to $100,000	$15,750 + 40 percent of pension income over $75,000
$100,000 to 150,000	$25,750 + 50 percent of pension income over $100,000
Over $150,000	$50,750 + 60 percent of pension income over $150,000

Excise Tax on Pensions of Nonresidents and Former Residents

The proposal also imposes an excise tax on the "fair market value" of vested pension benefits from California employers that are received by nonresident taxpayers and by people who move out of the state. Under the proposal, the state would levy an excise tax of 35 percent. Fair market value is defined as the amount of pension benefits above $50,000 that the taxpayer's vested pension benefits would provide on average over the individual's remaining life expectancy, as determined by the state Franchise Tax Board (FTB). The taxpayer would be permitted to pay the excise tax as a lump sum or over time.

FISCAL EFFECTS

The initiative could result in roughly $6 billion to $8 billion in additional General Fund revenues each year beginning in 2010. Over the long run, however, the level of new revenues likely would decline to the extent the measure stimulated behavioral changes in wage and pension practices. This is because, given the relatively high tax rates proposed in the initiative, it is likely that employers and individuals would take various steps to reduce pension-related tax liabilities. Employers, for instance, could shift the mix of compensation away from pensions and toward wages or other non-pension forms of retirement benefits. Similarly, the measure could encourage workers to leave the state as soon as the estimated value of their vested benefits approached $50,000 per year to avoid the excise tax. As no state has ever imposed a tax on pensions similar to the tax in this measure, no data are available to estimate the behavioral changes that would result from such a policy.

Potential Legal Problems of the Excise Tax. The measure raises legal issues that could result in the excise tax being invalidated under federal law. According to FTB, states are prohibited from imposing an income tax on the retirement income (from an in-state employer) of a nonresident. While the proposed excise tax is not technically a tax on current income, the outcome is similar (especially since this measure allows the excise tax to be paid over time). As a result, the excise tax may not survive a legal challenge. In that case, the annual revenue estimate would drop by $1 billion to $3 billion.

Summary of Fiscal Effect

The measure would have the following major fiscal effect:

- Annual state revenue increases of up to $6 billion to $8 billion beginning in 2010 from new taxes on pension benefits. Revenues likely would decline over time due to changes in behavior.

Sincerely,

Mac Taylor
Legislative Analyst

Michael C. Genest
Director of Finance