March 25, 2010

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 initiative entitled the "McCauley Pension Recovery Act" (A.G. File No. 10-0014).

BACKGROUND

The base of the state's personal income tax consists of (1) all income earned by California residents except for income attributable to activities in other states and (2) income earned by residents of other states attributable to activities in California. The state conforms to the federal treatment of pension income: the portion attributable to employer contributions is taxable but the fraction attributable to the taxpayer's own contributions is exempt.

PROPOSAL

The measure establishes new taxes on pension income beginning in 2012. Specifically, the measure creates:

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

Surcharge on Resident Pension Income

The proposal creates a new surcharge on pension taxable income in excess of $40,000. Unlike the current definition of "taxable pension income," pension taxable income includes all pension income whether attributable to employer or taxpayer contributions, plus employer-paid health insurance premiums. Pension income derived from employer contributions would also still be taxable as it is under current law.

The surcharge would increase as the amount of pension income increases, so that pension income above $150,000 would face 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. Taxpayers who were 75 or older on the date of enactment would receive a nonrefundable annual credit of $10,500 against the surcharge. Figure 1 displays the proposed surcharge schedule.

Figure 1

Proposed Pension Income Surcharge

Taxable Pension Income	Surcharge
Under $40,000	$0
$40,000-$50,000	$5,000 + 20 percent of pension income over $40,000
$50,000-$75,000	$7,000 + 35 percent of pension income over $50,000
$75,000-$100,000	$15,750 + 40 percent of pension income over $75,000
$100,000-$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 imposes a one-time 50 percent excise tax on the fair market value of "excess" vested pension benefits from California employers that are received by nonresident taxpayers and by people who reside in California on the date of enactment but later move out of the state. Excess benefits are defined as the amount above $40,000 per year 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. Taxpayers who were 75 or older on the date of enactment would receive a credit of $250,000 against the excise tax.

FISCAL EFFECTS

The initiative could result in $6 billion to $8 billion in additional General Fund revenues each year beginning in 2012 assuming no behavioral changes, but it would also likely induce behavioral changes that would be significant and very hard to quantify. Consequently, we conclude the measure could increase state revenues by several billion dollars annually. We discuss the impact of the proposed income tax surcharge and the excise tax separately below.

Income Tax Surcharge

The FTB estimates that the income tax surcharge would generate roughly $5 billion per year. This assumes that the new tax does not result in behavioral changes on the part of taxpayers or employers. Employers would have a strong incentive to shift the mix of compensation toward wages and salaries and away from pension benefits. Similarly, the measure would encourage workers to retire or leave the state as soon as the estimated value of their vested benefits (including employer-paid health insurance) approached $40,000 per year. As no state has ever imposed a tax on pensions at a rate even close to the rate proposed in this measure, no data are available to estimate the behavior changes that would result from such a policy.

Excise Tax on Nonresidents and Movers

The FTB estimates that the excise tax would generate annual revenue in the range of $1 billion to $3 billion, again assuming no behavioral changes designed to reduce tax liability. This estimate should be interpreted with caution, as data on the life expectancy of people with vested pensions who leave the state were not available. Also, taxpayers would have an incentive to leave the state before the date of enactment to avoid being counted as a resident of the state on that date.

Potential Legal Problems of the Excise Tax. The measure raises legal issues that may 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.

If a court were to strike down the excise tax, taxpayers subject to the surcharge would have an incentive to leave and would avoid any additional payments. Large-scale outmigration of retirees (who are no longer tied to the state by their jobs) could result, which would in turn induce job losses in health care and other sectors that support retirees. It is conceivable that revenue losses from such a reduction in the state's economic base could outweigh gains from the surcharge, causing a reduction in overall revenue.

Summary of Fiscal Effect

The measure would have the following major fiscal effect:

- Annual state revenue increases (assuming the excise tax is upheld) of up to several billion dollars beginning in 2012 from new taxes on pension benefits.

Sincerely,

Mac Taylor
Legislative Analyst

Ana J. Matosantos
Director of Finance