May 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. 10-0017).

BACKGROUND

The base of the state's personal income tax (PIT) consists of (1) all income earned by California residents except for income attributable to activities in other states and thus taxable in those 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 PIT 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 state definition of "taxable pension income," pension taxable income under the measure is identical to "retirement income" as defined in federal law and 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 increases 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 also 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 (1) $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) plus (2) the taxpayer's Social Security benefits. The taxpayer would be required to pay the excise tax as a lump sum. 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 up to $18 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. 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 $15 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. The excise tax is a one-time assessment based on the value of the taxpayer's benefits on the date of enactment. Taxpayers, therefore, would have only up until that date to change their behavior to reduce their liability. The excise tax would be hard to enforce due to the inability to collect information on nonresidents' benefits.

Potential Legal Problems of the Excise Tax. The measure raises legal issues that may result in the excise tax being invalidated. First, federal law prohibits states from imposing an income tax on the retirement income (from an in-state employer) of a nonresident. The proposed excise tax is not technically a tax on current income, but its base is derived from an annual income equivalent. Second, the U.S. Constitution prohibits disparate tax treatment of nonresidents in the absence of a substantial reason for the different treatment. It is not clear how a court would rule on these issues. 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 costs. This would likely result in a significant population shift with a corresponding effect on revenue and some types of spending, but no data are available to quantify this effect.

Summary of Fiscal Effect

The measure would have the following major fiscal effect:

- Potential annual state revenue increase of up to $18 billion beginning in 2012 and decreasing over time from new taxes on pension benefits. This estimate assumes the proposed excise tax is upheld by the courts.

Sincerely,

Mac Taylor
Legislative Analyst

Ana J. Matosantos
Director of Finance