

California's Tax System – Report #3b
Personal Income Tax Weakness & Possible Remedies:
Greater Simplification Can Be Achieved

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This is one in a series of reports on weaknesses in California's tax system. Report #1 listed several structural weaknesses and policy issues that exist in most of California's taxes and the system overall. Subsequent reports provide further details on each of the weaknesses and issues, along with possible remedies. The purpose of this series of reports is to help promote serious discussion on the need to and the ways to bring California's tax system into the 21st century so it may best promote economic growth, be more equitable, efficiently meet state revenue needs, reduce taxpayer frustration, and be understandable and transparent. A blog accompanies these reports to enable online discussion and a website exists to access the reports and the blog:

http://www.cob.sjsu.edu/nellen_a/TaxReform/21st_century_taxation.htm

Introduction to the Personal Income Tax

While our federal income tax has been around since 1913, the California personal income tax (PIT) only began in 1935. It was designed to generate a liability equal to about 25% of one's federal income tax liability. The formula to compute taxable income is very similar to what is used for federal income taxes, but not exact.¹ As of July 2007, the PIT conforms to the Internal Revenue Code (federal tax law) as it existed on January 1, 2005.²

PIT tax forms include both long and short versions.

The Franchise Tax Board administers the PIT and corporate income and franchise taxes. The FTB estimates that individuals and corporations voluntarily pay 86% of the taxes they owe. Through audit activity, the FTB collects another 3%.

Weakness: Complexities exist in the PIT in that it does not conform to the federal income tax completely, most individuals file the long tax form, and 11% of income taxes owed are not collected.

Remedy: Simplify PIT compliance by increasing its conformity to the federal income tax, implement ways to enable more taxpayers to use a shorter tax form and implement ways to reduce the tax gap including working with the federal government to create new reporting requirements.

Complexities in the California PIT

Conformity: The calculation of taxable income for the PIT begins with federal adjusted gross income (AGI). Most states with a personal income tax start the calculation of state taxable income using federal

¹ Doerr, David R. *California's Tax Machine*, California Taxpayers' Association, 2000, pages 37, 438-439.

² FTB Conformity Web site at <http://www.ftb.ca.gov/forms/updates/conformity.html>.

adjusted gross income. Nine states, including Colorado, North Carolina and Oregon, start with federal taxable income.³ Although a state starts its income tax calculation with federal taxable income, it may still have a significant number of adjustments to derive state taxable income.

For the PIT, various adjustments are made to federal AGI to account for deductions and exemptions allowed for the federal income tax, but not the PIT, or vice versa. When changes are made to the federal income tax (changes to the Internal Revenue Code), California does not automatically adopt such provisions. Instead, legislation is needed to adopt most of the changes. This can be done piecemeal with one piece of legislation conforming to a particular federal change or by one bill that adopts the federal law as of a certain date with specified exceptions.

Some federal changes may not be applicable for state purposes. For example, the federal change allowing taxpayers who itemize their deductions to deduct either their state income taxes or state sales tax does not apply in California because state taxes are not deductible on the California return. Also, legislators may decide not to adopt all of the federal changes or may not do so with the same effective date as the federal change. Thus, adjustments to federal AGI to derive California taxable income are due to differences between federal and California income tax rules as well as lags in California's adoption of some federal changes. Differences also exist in the types of and calculation of various tax credits.

The FTB is required to provide an annual report to the legislature on changes to the federal law and the estimated revenue impact of California conformity to the changes. The text of this provision follows:

Revenue & Taxation §19522 - Report to Legislature of changes in Internal Revenue Code; Proposed changes in section 17024.5

(a)(1)

(A) On or before the 10th of January each year, the Franchise Tax Board shall submit to the Legislature a report on all changes to the Internal Revenue Code enacted into law in the prior year. To the extent possible, the report shall contain an estimate of the revenue effect of conforming California law to each of those changes.

(B) In the event that changes to the Internal Revenue Code are enacted after September 15 of any year, the report described in subparagraph (A) shall be submitted to the Legislature within 120 days after signature by the President of the United States, rather than the 10th of January.

(2) The report required by this section shall be made available to the public.

(3) It is the intent of the Legislature that the policy committee of each house of the Legislature hold at least one public hearing on the report required by this section.

(b) For any introduced bill which proposes changes in any of the dates in Section 17024.5, the Franchise Tax Board shall prepare a complete analysis of the bill which describes all changes to state law which will automatically occur by reference to federal law as of the changed date. The Franchise Tax Board shall immediately update and supplement that analysis upon any amendment to the bill. That analysis shall be made available to the public and shall be submitted to the Legislature for publication in the daily journal of each house of the Legislature. The digest of the Legislative Counsel shall indicate that an analysis of the bill shall be prepared by the Franchise Tax Board and printed in the daily journal of each house of the Legislature.

The reports can be quite lengthy and involve many revenue estimates due to the large number of federal changes that often occur. For example, the FTB's report on 2006 federal changes is almost 700 pages. The FTB maintains a conformity web site with the reports and summary information on federal-California differences (<http://www.ftb.ca.gov/forms/updates/conformity.html>). R&T §17024.5 provides information on the dates and details of California conformity to federal law.

³ Federation of Tax Administrators, State Personal Income Taxes: Federal Starting Points, as of 1/1/07; available at http://www.taxadmin.org/fta/rate/inc_stp.html.

Differences between federal and California income tax rules can cause a variety of problems for individuals:

1. Errors: Individuals who are not aware that California does not conform to a particular federal provision are likely to calculate their PIT incorrectly, potentially subjecting themselves to penalties and interest.
2. Reduced effectiveness of some federal provisions: Where the federal law provides a taxpayer favorable rule that is not allowed in California, some taxpayers may decide not to take advantage of the federal provision in order to avoid additional California tax liabilities or to avoid having to track different tax attribute amounts for federal and California purposes. For example, federal law allowed taxpayers tax-free rollover for amounts moved from “Archer medical savings accounts” to health savings accounts. California did not adopt this provision thereby causing such rollovers to generate California tax liability, as well as penalties for making a disqualified distribution.⁴ To avoid the adverse California effect, some individuals may have forgone the rollover.
3. Additional recordkeeping: Differences in federal and state rules can also require taxpayers to keep two sets of records – one tracking federal tax attributes and the other state tax attributes. For example, differences in federal and state depreciation rules requires taxpayers to keep two sets of depreciation records so that they know the federal and California adjusted basis of each piece of property so they can calculate federal and state gain or loss upon disposition of the property.

Complexity also exists in that many individuals who owe little or no tax file the “long form” rather than one of the shorter forms. For 2005, the following numbers and types of PIT returns were filed:⁵

Form 540 2EZ	2.0 million (14.4%)
Form 540A (short form)	0.7 million (5.0%)
Form 540 (long form)	11.2 million (80.6%)

While only about 20% of individual filers used short tax forms, about 60% of individual returns filed for 2004 reported almost no tax liability. In 2004, the top 5% of returns based on AGI reported about 64% of the total PIT paid.⁶ Given the large number of individuals with zero or minimal tax liability, there seem to be far too many individuals filing the long form rather than the simpler short or EZ forms. Simpler filing requirements can improve compliance rates and reduce errors.

Tax gap: The FTB estimates that individuals and corporations voluntarily pay 86% of the taxes they owe. Through audit activity, the FTB collects another 3%. The remaining amount – 11% (about \$6.5 billion) represents California’s income tax gap. A tax gap is the amount of tax owed that is not collected. The FTB cannot be confident that the gap is not greater because it is difficult to measure the amount of some uncollected taxes, such as those attributable to businesses that do not report any or all of their income.⁷

Some portion of the tax gap is due to honest errors in misunderstanding the tax law. A more significant portion is likely due to failure to report income and claiming incorrect deductions. Weaknesses in the tax system can lead to all of these types of errors.

⁴ Assembly analysis to AB 115, 5/16/05; available at http://www.leginfo.ca.gov/pub/05-06/bill/asm/ab_0101-0150/ab_115_cfa_20050513_103247_asm_comm.html.

⁵ Franchise Tax Board, 2005 Annual Report, p. 15; available at <http://www.ftb.ca.gov/aboutftb/annrpt/2005/2005AR.pdf>.

⁶ *Id.*, p. 27.

⁷ Franchise Tax Board, *Tax Gap Plan: A Strategic Approach to Reducing California’s Tax Gap*, 2006, p. 4; available at <http://www.ftb.ca.gov/aboutFTB/TaxGapStratPlan.pdf>.

Why Improvements Should be Made

Simplification of the PIT would lead to more respect for the tax system, improved compliance rates, and savings in compliance costs for taxpayers.

Challenges

Often, California and federal income tax rules are not identical because the state may have good reasons for not conforming to a particular federal rule. For example, legislators may find that the state would lose too much revenue or have to increase tax rates if it adopted a new or expanded credit or deduction allowed for federal income tax purposes. Thus, it would be difficult to achieve complete conformity with federal income tax rules.

It is not possible to completely eliminate the tax gap, but viable measures to reduce it should be identified and enacted. There is a need to balance enforcement efforts and the return on such efforts. Some actions likely to reduce the tax gap depend on federal changes. For example, compliance is high for individuals who receive a W-2 statement. Thus, it is believed that if more independent contractors received a reporting form (Form 1099), compliance would also increase for these taxpayers. Federal law only requires individual independent contractors to receive a Form 1099 if the service recipient pays them \$600 or more during the year. California relies on federal reporting forms and for this type of change, would need to rely on the federal government.

Recommendations for Greater Simplification and Smaller Tax Gap

Conformity: The legislature needs to state how it will conform to new federal tax legislation earlier than it currently does. Confusion results when taxpayers must plan and file returns with different federal and California rules which may conform in a future year. A solution would be to enact legislation that California automatically conforms to federal law changes (other than tax rate changes) effective 30 days after enactment of the federal law. This provides the legislature 30 days to enact legislation to not conform to a particular provision. While the time frame is short, it is usually clear by tracking federal legislation to know when it is likely that a tax bill will pass and be signed by the President. Most details of the legislation are known months in advance providing opportunities for legislators and tax administrators to identify possible provisions where conformity would not be in the best interests of the state. Thus, there is no need to wait until the signing of the federal law to start drafting California legislation. The benefits of this approach would be more deliberate and timely consideration of whether California law will conform to federal law. This will make tax planning and compliance easier for most individuals.

Legislators and FTB staff should consider testifying before Congress periodically to encourage tax reductions through rate changes rather than the creation of new tax preferences (which raise conformity issues, as well as complexity to the tax law in general).

California will not want to conform to all federal changes as some may represent significant revenue costs for the state or represent bad tax policy. Legislators may also want to consider areas where non-conformity would be beneficial for the state. For example, some tax deductions and credits provide benefits beyond their intent. The home mortgage interest deduction is an example. The federal provision, which California conforms to, allows individuals to deduct mortgage interest on their principal and second home provided the mortgages do not total more than \$1.1 million. Given that there is no reason for the tax law to encourage ownership of more than a principal residence and that the median home price in even the highest cost-of-living areas in California is under \$1.1 million, this deduction is too broad. A deduction that is too broad (or favorable) provides a benefit to taxpayers that is not justified, paid for by other taxpayers who must pay more taxes to cover the “cost” of the tax preference. See Report #7b for more information on the potential benefits of a state reviewing its tax preferences (deductions, credits and exemptions).

Simpler compliance: The FTB should modify tax forms to enable more filers to use the shorter forms. In addition, educational efforts may be needed to help individuals to know when they may use the shorter forms. Further compliance simplifications should also be used such as telefiling and Ready Return.

Tax gap: Legislators and tax administrators should encourage Congress to simplify the tax law and increase reporting obligations to help reduce the tax gap. The FTB should identify taxpayers who receive a 1099-MISC for the first time indicating that they may have become self-employed. Educational information should be provided to such taxpayers to aid in proper compliance. Such information is also available from the EDD that requires information from new employers.

Studies should be conducted to get a better sense of causes of non-filing and underreporting of income. This should help in identifying appropriate solutions and targeting education and enforcement efforts.

Tax Policy Analysis⁸

The following chart explains how better conformity efforts would satisfy the principles of good tax policy. The rating in the last column indicates how better conformity practices would improve the current system.

Principle	Application and Analysis	Rating
Fairness		
Equity and Fairness Similarly situated taxpayers should be taxed similarly.	Likely no effect	
Transparency and Visibility Taxpayers should know that a tax exists and how and when it is imposed upon them and others.	Efforts to conform or announce non-conformity closer in time to the passage of federal tax legislation would help taxpayers to know what tax law applies for California purposes.	+
Operability		
Certainty The tax rules should clearly specify when the tax is to be paid, how it is to be paid, and how the amount to be paid is to be determined.	Efforts to conform or announce non-conformity closer in time to the passage of federal tax legislation would help taxpayers to know what tax law applies for California purposes.	+

⁸ This analysis uses a document prepared by the American Institute of Certified Public Accountants (AICPA) Tax Division and altered to the above format by Joint Venture: Silicon Valley Network. The AICPA document, *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals* (2001) is available at <http://ftp.aicpa.org/public/download/members/div/tax/3-01.pdf>. The Joint Venture workbook is available at <http://www.jointventure.org/PDF/taxworkbook.pdf>. The principles laid out in these documents are frequently used tax policy analyses ones. For more information see Nellen, *Policy Approach to Analyzing Tax Systems*; available at http://www.cob.sjsu.edu/facstaff/nellen_a/Policy%20Approach%20to%20Analyzing%20Tax%20Systems.pdf. Note: The author of this report (Annette Nellen) was the lead author for both the AICPA and Joint Venture documents noted here.

<p>Convenience of Payment A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayer.</p>	Likely no effect.	
<p>Economy in Collection The costs to collect a tax should be kept to a minimum for both the government and taxpayers.</p>	Efforts to conform or announce non-conformity closer in time to the passage of federal tax legislation would help taxpayers to know what tax law applies for California purposes and simplify compliance and tax planning.	+
<p>Simplicity The tax law should be simple so that taxpayers can understand the rules and comply with them correctly and in a cost-efficient manner.</p>	Efforts to conform or announce non-conformity closer in time to the passage of federal tax legislation would help taxpayers to know what tax law applies for California purposes which would simplify tax planning and compliance.	+
<p>Minimum Tax Gap A tax should be structured to minimize non-compliance.”</p>	Better conformity efforts should reduce errors where individuals believe a federal preference applies for California purposes when it does not.	+
<p>Appropriate Government Revenues The tax system should enable the government to determine how much tax revenue will likely be collected and when.</p>	Likely no effect	
Appropriate Purpose and Goals		
<p>Neutrality The effect of the tax law on a taxpayer’s decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.</p>	Likely no effect.	
<p>Economic Growth and Efficiency The tax system should not impede or reduce the productive capacity of the economy.</p>	Likely no effect.	

Additional Reading

Federation of Tax Administrators, *State Personal Income Taxes: Federal Starting Points*, 1/1/07; available at http://www.taxadmin.org/fta/rate/stg_pts.pdf.

Franchise Tax Board, *2005 Annual Report*; available at <http://www.ftb.ca.gov/aboutftb/annrpt/2005/2005AR.pdf>.

Franchise Tax Board, *Ready Return filing information*; available at <http://www.ftb.ca.gov/readyReturn/about.html>.

Franchise Tax Board, *Tax Gap Plan: A Strategic Approach to Reducing California’s Tax Gap*, 2006; available at <http://www.ftb.ca.gov/aboutFTB/TaxGapStratPlan.pdf>.