California's Tax System – Report #7b

Personal Income Tax Weakness & Possible Remedies: Outdated and Inequitable Tax Provisions

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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

Overview

In order to tax income, decisions must be made as to how income should be measured. In some ways, the decisions for businesses are easier than for individuals because it is generally assumed that businesses may reduce their gross receipts by the expenses incurred to produce those receipts. But, what expenditures should individuals be allowed to subtract from their gross income? For many decades, the system has followed a policy decision based on *ability-to-pay*. Thus, some type of exemption (deduction) should be allowed for the taxpayer, spouse and dependents, on the assumption that individuals need some level of income to live on that should not be taxed. However, not all expenditures that affect ability-to-pay are allowed as deductions in computing taxable income.

Legislators realize that they can implement many non-tax policies through the tax system in that it is a way to provide a government benefit to someone or to encourage (or discourage) someone from doing something. For example, the government might encourage more individuals to consider buying a hybrid fuel car by offering a tax credit for doing so. This type of tax break or benefit is not for the purposes of measuring taxable income, but for providing a benefit to certain taxpayers. These types of benefits, of which there are over 100 in the federal and California income tax systems, result in reduced tax collections over what could be collected if these breaks were not part of the tax rules.

Both the federal and California governments measure the annual cost of most of these tax provisions. The process is referred to as measuring "tax expenditures." A "tax expenditure" is a provision in a tax system that results in reduced tax collections. For example, a deduction for property taxes in the income tax reduces taxable income and thus tax liability. Thus, the property tax deduction is a tax expenditure. A tax expenditure might also just reflect choice of a rule on how to measure something, such as depreciation (such as straight line versus double-declining balance). The California Department of Finance (DOF) is required to issue an annual report of tax expenditures of $5 million or more (in terms of revenue not collected due to the particular tax expenditure).[1] In defining tax expenditure for its report, the Department

[1] California Department of Finance; annual reports can be found at http://www.dof.ca.gov/Research/Research.php. Tax expenditure reports by the Franchise Tax Board can be found at

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of Finance does not include a tax system feature that is part of the basic structure of the tax. For example, California's sales tax statute bases the tax primarily on tangible personal property. Thus, the DOF does not include the inherent sales tax exemption for services and intangible property on its list of tax expenditures.

Most tax expenditures are permanent rules in the tax law rather than temporary provisions that must be reviewed when the expiration date nears. Thus, tax expenditures are rarely reviewed. If there is a need to generate additional revenue, some of the tax expenditures may come under review and be reduced or eliminated. A significant example of this occurred with the federal Tax Reform Act of 1986. That Act broadened the income tax base and lowered tax rates. Several deductions and tax credits were eliminated, such as the deductions for personal interest, as well as the investment tax credit. The lack of annual review of government spending in the form of tax expenditures is that the revenue effect of the provisions goes unchecked other than in overall projections of tax collections. For example, when the price of housing increases, people take out more debt to purchase a home and government revenues drop because individuals claim higher mortgage interest deductions. The change in the budget from this effect goes unchecked in the annual budget process.

Tax expenditures also go mostly unchecked because in critiquing an annual budget, they are overlooked because they are not part of that budget (that is, they are not listed as a spending item). In addition, in California, the process for implementing a tax expenditure (tax break) differs from direct spending in the budget process. In California, a tax break can be enacted with a simple majority vote of the legislature while the California budget approval requires a 2/3 majority vote. In addition, should the legislature want to reduce or eliminate a tax break, a 2/3 majority vote is required since the result would be increased taxes.

Generally, tax expenditures are a form of government spending because a decision is made when the deduction, exemption or credit is put in the law that it is appropriate to reduce government tax revenues to provide the tax rule.

This report includes a list of California tax expenditures that could be eliminated or pared down so as to improve equity and fairness in the tax law and to improve California's budget situation (by increasing tax revenues).

Weakness: The California personal income tax system contains many tax breaks that reduce revenues collected by the government. While many serve an important purpose, many are outdated, unnecessary and/or too generous which causes the system to violate key tax principles of equity, transparency, simplicity, neutrality and economic growth and efficiency.

Remedy: Review all tax breaks for appropriateness, usefulness and equity and develop plans to modify or eliminate ones that are not justified. Create a procedure for regular review of all tax breaks.

Additional Observations on Tax Expenditures and Reform

Reasons for special tax provisions: Reasons why favorable tax provisions are included in California tax rules include:[2]

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http://www.ftb.ca.gov/aboutftb/plans_reports.shtml. The federal government also reports annually on the "cost" of tax expenditures in the federal tax laws. The latest report from the Joint Committee on Taxation can be found at http://www.house.gov/jec/fiscal/tax/expend.pdf.

[2] See CA Department of Finance, *Tax Expenditure Report 2007-08*, page 2; http://www.dof.ca.gov/Research/documents/Tax_Expenditure_Rpt_07-08.pdf.

- To conform the California income tax to the federal income tax law.
- To remove a treatment that is perceived to be unfair or inequitable.
- To improve administration of the tax laws.
- To provide a specific benefit to a type of taxpayer, or a particular activity.

Problems due to lack of annual review: The result of lack of regular review of tax expenditures is that some of them have outlived their usefulness or appropriateness. For example, many years ago, many senior citizens had low income and perhaps an across the board tax credit for all of them was warranted. However, today, many senior citizens are quite wealthy, yet many continue to get an income tax credit even when income is well beyond the poverty level.

In addition, lack of annual review prevents the updated cost of the benefit from being considered.

Some tax expenditures lacked appropriateness from the start, but perhaps the provision was enacted because it did not affect many individuals. However, continuation of the tax break could grow over the years increasing the inequity of that use of tax dollars. An example would be the home mortgage interest deduction (see chart below for more information).

Lack of targeting the expenditure: Some tax provisions are not targeted to the population that the benefit is intended to serve or it may favor higher income individuals. For example, the California senior exemption applies to many senior citizens with income well above the poverty level. Also, the exclusion for the value of health insurance provided by an employer provides a great benefit to high-income employees as they may get a larger benefit from their employer and the exclusion is worth more to them because they are in a high tax bracket.

Complexity: Generally, special rules, such as for home mortgage interest or certain gain exclusions add complexity to the law because of the definitions and special rules that are required to comply with the rule.

Removal or reduction of California tax provision can still provide benefit at federal level: Many of the California income tax expenditures also exist in the federal income tax. If California reduced the tax benefit, the taxpayer would still obtain a benefit at the federal level. While the taxpayer would have a new adjustment to convert federal taxable income to California taxable income, that should not be too challenging of a task. Basically, if California cuts back a tax break that also exists at the federal level, taxpayers still derive some benefit of the activity that generates the federal benefit. However, there are many tax expenditures that should also be reconsidered at the federal level for the same reasons they should be reconsidered for the PIT.

Distribution of benefits generally uneven across income levels: Tax benefits in the form of deductions tend to favor higher income taxpayers because they are in higher tax brackets (an exception is for deductions that are not available for higher income taxpayers). Also, tax credits may also favor higher income taxpayers because credits generally are not refundable (they reduce tax liability to zero with any excess credit vanishing or carrying forward to future years with no adjustment for the time value of money).

For example, the FTB reports that the senior exemption and real property tax deduction across income levels for 2002 tax returns was as follows.[3]

	Senior exemption credit		**Real property tax deduction**		
Adjusted gross income class	# returns reporting credit (000's of returns)	Amount of credit claimed (millions of dollars)	# returns using deduction (000's of returns)	Amount of deduction claimed (millions of	Tax impact of deduction (millions of dollars)

[3] Franchise Tax Board, *Income Tax Expenditures*, 8/06, pages 34 and 74; http://www.ftb.ca.gov/aboutftb/plans_reports.shtml.

				dollars)	
Less than $10,000	0	0	0.1	471	0.03
$10,000 - $19,999	52.3	4.3	21.6	502	0.42
$20,000 - $49,999	348.4	28.6	691.6	2,669	54
$50,000 - $99,999	403.7	33.1	1,748.2	5,028	310
$100,000 - $199,999	145.1	11.9	1,004.3	4,193	369
Over $199,999	75.1	6.2	363.8	3,012	250
Total	1,197	98	3,839.5	15,873.8	984.8

For the senior exemption, 18.5% of the dollar benefit went to individuals with income of $100,000 or more while 52.2% went to those with incomes of $50,000 or more. The real property tax deduction was even more skewed to higher income individuals with 62.9% of the benefit going to those with income of $100,000 or more and 94.3% going to those with income of $50,000 or more. Part of the reason for the difference in benefit is that the senior benefit is a tax credit and so provides the same dollar-for-dollar benefit for all taxpayers (unless the credit is greater than the tax owed), while the other is a deduction and so provides a bigger benefit for those in higher tax brackets (those with higher incomes). In addition, a taxpayer must itemize deductions in order to deduct real property taxes.

Tax gap issues: The California Legislative Analyst's Office (LAO) notes that some tax expenditures create "serious enforcement problems" by offering "many opportunities for tax evasion, especially given the relatively low level of tax auditing the state undertakes."[4]

Deductions versus credits: Tax expenditures in the form of tax deductions, yield greater benefit to taxpayers in higher tax brackets. For example, assume two individuals each have a mortgage interest deduction of $5,000. For a higher income individual with a marginal California income tax rate of 9.3%, that deduction provides a benefit of $465. For a lower income individual with a marginal tax rate of 4%, the tax benefit of the deduction is $200. Greater equity could be provided for many tax breaks by converting them from deductions into tax credits. Tax credits are dollar-for-dollar reductions in tax liabilities. A credit of $50 is worth $50 to all taxpayers regardless of their marginal tax rate. Thus, a mortgage interest tax credit equal to 5% of one's mortgage interest represents a tax savings of $250 for both of the individuals in the prior example (who each have mortgage interest of $5,000).

Reform can support a rate reduction: In addition to generating revenue, reduction in some tax breaks could be combined with a reduction in tax rates which would also cause the change to be perceived as less onerous. In its 2006 report on tax expenditures, the FTB reported that elimination of the mortgage interest deduction could allow for a 10% across-the-board rate cut with the personal income tax still generating the same amount of revenue. Similarly, the FTB reported that elimination of the R&D tax credit for corporations could allow for a revenue-neutral rate reduction of 7%.[5]

Taxing exclusions still yields taxpayer benefit: Some of the tax breaks are exclusions where something that meets the definition of income is allowed to be excluded from taxable income. The exclusion for employer-provided health insurance is an example. Assume that an employer pays $10,000 during the year towards an employee's health insurance costs. That financial benefit is generally excluded from the employee's taxable income. If instead, all or part of that exclusion were subject to tax, the employee would still be financially ahead. For example, if the employee is in a 9.3% marginal tax bracket, including the $10,000 in income results in $930 of tax owed. The employee has obtained a $10,000 health insurance benefit for only $930.

Another perspective: A 1999 report from the Joint Economic Committee questioned the propriety of using the term "tax expenditures" to describe tax exemptions, special deductions and credits. The report noted

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[4] LAO, Tax Expenditures and Revenue Options, Presented to: Assembly Revenue and Taxation Committee, 4/7/08, pg. 7; http://www.lao.ca.gov/handouts/Econ/2008/Tax_Expend_04_07_08.pdf.

[5] Franchise Tax Board, *Income Tax Expenditures*, 8/06, page 6; http://www.ftb.ca.gov/aboutftb/plans_reports.shtml.

that the tax expenditure approach took the view that one's income really belongs to the government rather than to the taxpayer. The report also noted that the concept of tax expenditures is problematic in that the federal income tax is a combination of an income and a consumption tax.[6] Arguably, this theory downplays the lack of equity that exists in many tax expenditures.

Another positive perspective on tax expenditures is that they encourage a particular activity without the need for a government agency to oversee it. For example, instead of a research tax credit, the government could provide research grants through a competitive process. However, that would require that a special agency be set up to handle the grant request, review and monitoring function.

Not just personal income tax: Tax breaks exist in other California taxes including the corporate franchise tax, the sales tax and other taxes. The DOF and FTB reports include the data on these tax expenditures. Significant tax expenditures in these other taxes include (08/09 DOF data):

- Corporate tax
  - Subchapter S corporations[7] $1,025 million
  - R&D credit $1,023 million
- Sales and use tax (state and local cost)
  - Food products exemption $6,451 million
  - Gas, electricity, water and steam $3,491 million
  - Prescription drugs $2,732 million

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[6] Joint Economic Committee, *Tax Expenditures: A Review and Analysis*, August 1999; http://www.house.gov/jec/fiscal/tax/expend.pdf.

[7] For federal income tax purposes, S corporations are taxed as pass-through entities (income taxed to owners), generally with no entity level tax. California also taxes them as pass-through entities, but also assesses an entity level tax at a rate of 1.5%.

Critique of Selected California Personal Income Tax Expenditures: Where Changes Are Justified for Fairness & Equity

The chart below lists selected tax expenditures of $5 million or more that the Department of Finance included in its 07/08 annual report. The ones listed in the chart are some of the ones that the author believes warrant review as being too generous, inappropriate or no longer useful. All of those listed also represent a source of revenue in that cutting back on the tax expenditure is, in effect, a spending cut. A complete list of the tax expenditures that cost $5 million or more can be found at the Department of Finance website (http://www.dof.ca.gov/Research/Research.php).

Tax Expenditure	Revenue Loss 08/09 (millions) [8]	Explanation	Critique	Possible Improvement
Home mortgage interest deduction	$5,695	The CA rule is based on federal law. Individuals who itemize their deductions are allowed to deduct mortgage interest on a principal residence and one other home (such as a vacation home). The debt limit is $1 million of acquisition debt and $100,000 of home mortgage interest.	While there are societal and economic reasons for a government to encourage home ownership, the rule is too broad. The deduction applies to two homes rather than just a principal residence. Also, $1 million of acquisition indebtedness is far greater than the median home price (per the California Association of Realtors, it was just under $500,000 at 11/07).[9] Finally, the allowance of a deduction for interest on home equity indebtedness is unfair in that it provides a technique for homeowners to obtain deductible mortgage interest that is not available to someone who does not own a home. For example, a homeowner could obtain a home equity loan of up to $100,000 to pay for a child's college tuition and deduct the interest. In contrast, a person who does not own a home (or has no equity in the home) and borrows from a bank to pay for tuition may not deduct the interest expense. The home equity loan may be used for any purpose including the purchase of the home (thus potentially allowing for interest deductions on a home mortgage of $1.1 million) – far greater than the median home price in any California county.	1. Gradually phase-out the deduction for interest on home equity indebtedness over a five year period. 2. Gradually reduce the debt limit for acquisition indebtedness until it becomes 80% of the median home price in the geographic region. Adjust the limit annually, but only for debt on new acquisitions. 3. Gradually phase-out the deduction for home mortgage interest that is not for a principal residence. 4. Consider converting a reduced and targeted benefit to a tax credit rather than a deduction so it provides an equivalent benefit regardless of tax bracket.[10]

[8] The amounts in the California Dept. of Finance reports do not tie exactly to those in the FTB tax expenditure reports.
[9] California Association of Realtors, 12/21/07; http://www.car.org/index.php?id=MzgwNzU=.
[10] This was proposed by President Bush's Advisory Panel on Federal Tax Reform, Final Report, 11/05 pg. 73; http://www.taxpolicycenter.org/newsevents/trp_recommendations.pdf.

Exclusion of employer contributions to health plans	$3,690	Employers who pay for all or part of an employee's health insurance plan may deduct that cost. The benefit is not taxable to the employee.	While there are advantages to the government of more people being covered by health insurance, this provision is generous. There is also a rule that allows self-employed individuals to deduct qualified health insurance costs. Arguably, these rules are inequitable because the government benefit is not provided to everyone – only employees or self-employeds who get health insurance coverage from their employer. This rule and its cost should be reviewed as a source of funds to enable the government to more broadly subsidize all individuals who require health insurance and to potentially also generate revenue for the General Fund.	Allow an exclusion for only 75% of the employer-provided health insurance. Employers would need to report the amount of the benefit on Form W-2. Alternatively, the benefit could be reduced with a greater reduction for higher income individuals to target the relief (subsidy) to those who need it the most.
Exclusion of benefits provided under cafeteria plans	$1,470	The value of benefits received by an employee from an employer's cafeteria plan are not subject to tax by the employee although the employer claims a deduction.	Similar to the health insurance benefit (see earlier entry), this benefit could be reduced (such as by requiring some percentage of the benefit to be included in income) to provide equity with employees and others who do not receive these benefits.	Allow an exclusion for only 75% of the cafeteria plan benefit. Employers would need to report the amount of the benefit on Form W-2. Alternatively, the benefit could be reduced with a greater reduction for higher income individuals to target the relief (subsidy) to those who need it the most.
Deduction of health insurance by self-employed	$173	Self-employed individuals may deduct the cost of health insurance for themselves and their families. This is not an itemized deduction.	This deduction exists to attempt to equalize the benefit employees with employer-provided health insurance receive. Any reduction in that benefit should be matched with a reduction in the deduction for self-employed individuals.	Provide a sliding scale of deductions based on the self-employed individual's tax bracket.
Exclusion of capital gains on sale of a principal residence.	$3,683	Homeowners are allowed to exclude up to $250,000 ($500,000 if married filing jointly) of the gain from the sale of their principal residence if they have owned and lived in the home for at least 2 of the prior 5 years. The rule may	This rule is arguably too generous. While it is not uncommon for many homeowners in California to have gains of $500,000 on their home sale, the structure of the rule incentives individuals with more than one home to take advantage of this significant tax break. For example, a married couple who own a personal residence and a vacation residence can sell the personal home and exclude the gain and then move into the vacation home for at least 2 years prior to selling it and exclude that gain as well (up to $500,000). They can do the same with rental homes they	Enact the limitation that was proposed in the original version of H.R. 3648 (see column to the left) or change the provision to a lifetime exclusion, adjusted for inflation.

		only be used once in a 2-year period. This provision may be used more than once in a lifetime.	may own (although the portion of the gain from depreciation will be taxed). This rule provides a generous tax break to those owning a home and an even greater tax break to those who own more than one home or who buy and sell homes several times in their lifetime with large gains. In 2007, the 110th Congress included a provision in the original version of the mortgage debt relief bill (H.R. 3648) to reduce the generous nature of the home sale gain exclusion (the provision was removed from the bill that was enacted). H.R. 3648 would have exempted gain attributable to periods of non-qualified use from the gain exclusion rule. Some type of cut back to the gain exclusion rule would bring greater equity to the income tax.	

Basis step-up on inherited property	$3,170	When a person dies, their estate typically uses the fair market value (FMV) of assets at date of death. That figure is used to calculate any estate taxes that might be owed. Individuals inheriting property receive it with a tax basis equal to that same FMV. Thus, if Aunt Jane has XYZ stock with a basis of $10 and FMV of $100 at date of death, Nephew Sam has a basis of $100 in the inherited stock and the $90 of gain is not included in taxable income of either Jane or Sam.	The California rule is based on the federal rule. While the federal government has an estate tax, which will capture (for estate tax purposes), any built-in gain of assets at date of death, it is not the same as subjecting such gains to income tax for either the deceased or the person who inherits the property. Also, not all estates are large enough to owe federal estate taxes. Arguably, since California does not even have an estate tax that might result in some of the gain being subject to tax, it is even more justified to tax the built-in gain either to the decedent (on the last income tax return) or to the person inheriting (such as when it is eventually sold by that person). A problem with this approach though is that taxpayers will have different basis in inherited property for federal and California purposes which would likely lead to some compliance difficulties.	Require individuals inheriting property to record their California tax basis as equal to that of the decedent so that upon eventual sale, a gain (or loss) is taxed.
Exclusion of Social Security benefits	$1,735	The federal income tax requires some individuals to pay tax on up to 85% of their Social Security income depending on their income level. Low-income taxpayers do not need to include any Social Security income. California does not tax	There seems to be no good reason why California would want to exclude income that the federal government taxes when the test for inclusion is based on income.[11] Some other states also exempt Social Security income, but others, such as Colorado and Connecticut, do not.	Phase-out this exclusion gradually over a 5 year period.

[11] There are reasons for the federal income tax law to exempt 50% of one's Social Security income because employee contributions to Social Security are taxed (employer contributions were deducted by the corporation). However, the federal government made a decision several years ago to tax up to 85% of Social Security income for higher income individuals.

		any Social Security income.		
Charitable contributions deduction	$1,570	Individuals (and corporations) who itemize deductions and make cash or non-cash contributions to qualified charitable organizations may claim the contributions as a tax deduction.	Arguments could be made to justify reducing this tax break on the basis that contributions should be made by the donor without assistance (in the form of reduced taxes) from the government. An additional argument is that not all charitable organizations serve the same public assistance need. For example, a donation to an organization that helps homeless people find shelter yields the same tax deduction benefit to a taxpayer as does a donation to a private university with a $30 billion endowment. Similarly, a donation to an organization that devotes 80% of its donations to the charitable purpose yields the same deduction as a donation to an organization with operating expenses higher than its charitable spending.	1. Allow only a percentage of the federal charitable contribution deduction to be allowed in computing California taxable income. 2. Reduce the deduction for organizations that meet certain criteria, such as the number of low-income people they serve or based on the ratio of operating expenses to revenues.
Real estate deduction	$1,262	Individuals who pay real property taxes and itemize their deductions may deduct real estate taxes. They may also deduct personal property taxes, such as those paid on a car.	Not all state taxes are deductible. The federal income tax law allows for itemized deductions for state income and property taxes. California allows a deduction for property taxes only. Arguably, special treatment for one type of state tax is inequitable and this deduction could be cut back.	Eliminate or only allow a percentage of the federal real estate deduction to be allowed in computing California taxable income.
Exclusion of investment income on life insurance and annuity contracts	$1,230	As with federal income tax law, a beneficiary receiving life insurance proceeds is not required to include them in income.	The rationale for the exclusion likely is that the beneficiary needs all of the proceeds. Unlike the employer-provide health insurance situation, the owner of the life insurance policy has not deducted the life insurance premiums. Justification for taxing all or part of the life insurance proceeds is that the owner can plan for this via the amount of life insurance purchased, and it is a windfall for the beneficiary that does increase one's net wealth.	Require some small percentage of the income to be taxable to the recipient.
Exemption for senior citizens	$125	A tax exemption (credit) is allowed for individuals age 65 or older. The credit was worth $94 in 2007.	This tax benefit is poorly targeted as it applies to almost all seniors regardless of need. The phase-out of the exemption starts at income levels well above the poverty level. For 2007, these phase-out ranges were $155,416 if single and $310,837 if married.	Change the credit to be a range based on income levels with the credit completely phased out for seniors with income of a specified dollar amount that is far lower than current law, adjusted annually for inflation.

				For example, the credit could be $90 for those with income under $25,000, $60 for those with income below $50,000, $30 for those with income below $75,000 and zero for all others.

Challenges

Cutting back or eliminating tax breaks is never easy because each one has a group of taxpayers who will want to keep it, perhaps even if a rate decrease accompanies the cut back. Change will also be difficult because many taxpayers, particularly individuals, are not aware of these breaks. For example, most people with employer-provided health insurance do not even know the amount of the benefit and that the government is providing them a subsidy by not requiring that financial benefit/gain to be included in taxable income.

Elimination of any tax expenditure will not necessarily mean that those dollars will translate into additional revenue due to behavior changes taxpayers may engage in. For example, if the charitable contribution deduction were cut back, people might make fewer contributions which might eventually result in a need for greater government expenditures to provide welfare assistance previously provided by charities.

Recommendations

- Educational efforts will be needed to let people know of the costs and inequities that exist in many of the tax breaks. For example, since the majority of individuals do not own two homes and do not have mortgage interest even close to $1.1 million, a majority are likely to view this tax break as too generous.
- Start with tax expenditures that present the most glaring inequities.
- Provide transitional rules so that the tax breaks are phased out so taxpayers have time to adjust to their new tax liabilities.
- Along with cutting back on tax expenditures, reduce the tax rate.
- Create a procedure that allows for periodic legislative review of all tax breaks to be sure they continue to be appropriate and a cost-effective way to achieve the desired economic or social policy outcome.
- Enact a rule that new tax breaks that cannot be enacted without also cutting back on some other tax break unless specified criteria are satisfied.
- Encourage Congress to make similar changes to the federal tax law.

Tax Policy Analysis[12]

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.

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[12] 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/nellen_a/TaxReform/PolicyApproachToAnalyzingTaxSystems.pdf. Note: The author of this report (Annette Nellen) was the lead author for both the AICPA and Joint Venture documents noted here.

Principle	Application and Analysis	Rating
Fairness		
Equity and Fairness Similarly situated taxpayers should be taxed similarly.	A review of tax expenditures in the personal income tax (PIT) can bring greater equity to the system. Today, many of the tax breaks in the PIT are skewed in favor of higher income individuals. For example, assume an employer contributes $10,000 to provide health insurance to two employees. Employee A is in a 9.3% PIT bracket while employee B is in a 4% bracket. The non-taxability of this $10,000 benefit to A is $930 and to B is $400. A reduction in this benefit, such as where A must include some percentage of the benefit in income or conversion of the deduction to a tax credit would equalize the benefit. Similarly, reduction of tax expenditures that have lost sight of a valid purpose, such as a home mortgage deduction on two homes and on up to $1.1 million of debt, would provide equity to the tax system as typically only high income individuals can afford to take advantage of this generous rule.	+
Transparency and Visibility Taxpayers should know that a tax exists and how and when it is imposed upon them and others.	Reducing the number of tax breaks could bring greater transparency to the PIT. For example, many employees with employer-provided health insurance likely do not know the value of this benefit even though it is a form of compensation, because it is not included in their taxable wages. Taxing a portion of this benefit would require employees to have to report the amount on their return and they would have a better understanding of how much is taxable and how much is tax-exempt.	+
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.	Likely no effect.	
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.	Likely no effect.	
Economy in Collection The costs to collect a tax should be kept to a minimum for both the government and taxpayers.	Likely no effect.	
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.	If reduction in a tax break leads to a different treatment of an income or expense item from its federal income tax treatment, complexity would increase.	-
Minimum Tax Gap A tax should be structured to minimize non-compliance."	Likely no effect.	
Appropriate Government Revenues	Likely no effect.	

The tax system should enable the government to determine how much tax revenue will likely be collected and when.		
Appropriate Purpose and Goals		
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.	Reduction or removal of some tax expenditures should generally make the PIT more neutral. For example, today, a taxpayer who can afford it, may be inclined to take on a large home mortgage because of the large debt limit for deducting home mortgage interest. A reduced debt limit would reduce the effect of tax considerations from the decision as to mortgage size.	+
Economic Growth and Efficiency The tax system should not impede or reduce the productive capacity of the economy.	Tax breaks can lead to overinvestment in tax-favored activities. For example, the large home mortgage limit and favorable treatment of gains from sale of a home lead to overinvestment in residences relative to other types of investment. The final report of President Bush's Advisory Panel on Federal Tax Reform (11/05) notes that the effective tax rate on owner-occupied housing is 0% while that ETR on corporate business investment is 26%.[13] The generous tax benefits for employer-provided health insurance can also lead to excess insurance coverage and increase prices of insurance for everyone.[14] These effects distort economic decisions and raise the cost of competing investments. Reduction or removal of some tax breaks can improve economic efficiency.	+

Additional Reading

CA Department of Finance, *Tax Expenditure Report 2007-08*; http://www.dof.ca.gov/Research/documents/Tax_Expenditure_Rpt_07-08.pdf.

Franchise Tax Board, *Income Tax Expenditures*, 12/07; http://www.ftb.ca.gov/aboutftb/taxexp07.pdf.

Joint Committee on Taxation, tax expenditure reports; http://www.house.gov/jct/pubs_taxexpend.html.

LAO, Tax Expenditures and Revenue Options, Presented to: Assembly Revenue and Taxation Committee, 4/7/08; http://www.lao.ca.gov/handouts/Econ/2008/Tax_Expend_04_07_08.pdf.

[13] President's Panel on Federal Tax Reform, Final Report, 11/05, Chapter 5, page 71; http://taxreformpanel.gov/final-report/. Also see Treasury Background Paper on Business Taxation and Global Competitiveness, 7/07, page 24; http://www.treasury.gov/press/releases/reports/07230%20r.pdf.

[14] President's Panel on Federal Tax Reform, Final Report, 11/05, Chapter 1, page 8; http://taxreformpanel.gov/final-report/.