

## THE 2002 STATE BUDGET

# TAX AND REVENUE MEASURES

The 2002 Budget Package includes tax revisions and revenue enhancements that generate an additional \$2.9 billion of General Fund revenue in 2002-03 without any ongoing general tax increase. The tax-related provisions of the budget package consist of (1) legislation enacted in May which included most of the Governor's January proposals for pension and other federal conformity changes along with several additional elements, (2) omnibus budget trailer legislation that contains the bulk of the revenue enhancements, and (3) other measures, including budget augmentations for audit and collection resources that produce additional revenues.

## May Tax Conformity Legislation

SB 657 (Scott) and AB 1122 (Corbett) Chapters 34 and 35, Statutes of 2002, enacted state income tax conformity with federal pension and retirement tax changes made by the Economic Growth and Tax Relief Reconciliation Act of 2001. These changes avoid conflicts between federal and state tax law and enable Californians to take advantage of expanded tax benefits for retirement savings. Including other changes and a one-time revenue acceleration, these measures increase General Fund revenues by a net total of \$189 million in 2002-03. (There is no net revenue impact in 2003-04 and small net revenue reductions in subsequent years). Table 1 summarizes the estimated revenue effect of SB 657 and AB 1122 in 2002-03.

**Table 1**  
**SB 657 and AB 1122--Estimated General Fund Revenues**  
**2002-03**  
(in Millions)

Pension/IRA conformity	-\$44
Exclude charitable contributions of appreciated property from alternative minimum tax (AMT) and increase deductions for contributions of appreciated stock to private foundations	-17
Conformity for qualified tuition plans	-1
Eliminate deductions of S corporation losses	2
Various 1998 through 2000 federal conformity changes	5
Require federal S corporations to have same status for state tax purposes	10
Eliminate deductions for club dues, lobbying, executive compensation greater than \$1 million	23
Increase estimated payment percentage (revenue acceleration)	<u>210</u>
<b>Total</b>	<b>\$189</b>
Detail does not add to total due to rounding.	

## ■ Major components of SB 657 and AB 1122

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The May tax conformity measures include the following changes in state tax law:

- **Critical retirement plan changes.** These conform to changes made in the federal Economic Growth and Tax Relief Reconciliation Act of 2001 and include increased Individual Retirement Account (IRA) contribution limits (from \$2,000 to \$3,000 in 2002 and up to \$5,000 by 2008, and indexed thereafter), pension (401k, 457, 403b, SEPs) catch-up contributions for individuals age 50 or older (an additional \$1,000 in 2002 rising to \$5,000 by 2006, and indexed thereafter), changes in rules for defined benefit and SIMPLE plans, and increased limits on deferrals under state and local deferred compensation plans.
- **Charitable Contributions of Property.** These changes conform to Federal law, which does not treat charitable contributions of certain appreciated property as a tax preference item subject to the AMT, and provides more generous deductions for gifts of appreciated stock to foundations.
- **Qualified Tuition Plans.** Distributions from qualified tuition savings programs, such as California's Golden State Scholarshare Program, are now tax-free, rather than being included in the income of the student.
- **S Corporations and Loss Limitations.** These changes require businesses that elect Subchapter S status for federal tax purposes to make the same election for state tax purposes. They also prevent taxpayers from deducting losses that are not actually borne by the taxpayer.
- **1998 - 2000 Federal Conformity.** These include a variety of changes that conform to prior federal tax law changes.
- **Limits on Business Deductions.** These changes conform to federal law that denies business tax deductions for club dues, lobbying expenses, and executive compensation in excess of \$1 million.
- **Estimated Payment Rules.** To avoid underpayment penalties under federal law, 90 percent of tax due for the year must be paid either through withholding or estimated tax payments. California's requirement was only 80 percent. This change conforms state law to federal law and provides a revenue acceleration of \$210 million in 2002-03. However, this gain will be one-time because there is no change total tax liability—increased payments in subsequent years will be offset by reduced final payments.

## AB 2065—Omnibus Revenue and Taxation Budget Trailer Bill

AB 2065 (Oropeza), chapter 488 Statutes of 2002, increases General Fund revenue by \$2.4 billion in 2002-03. Table 2 shows the components of this revenue increase.

**Table 2**  
**AB 2065--Estimated General Fund Revenues**  
**2002-03**  
 (in Millions)

Suspend carryover deductions of net operating losses (NOLs) for two years	\$1,200
Increase withholding rate for stock option and bonus income	400
Federal conformity for treatment of bank bad debt	285
Withholding for real estate sales	225
Suspend teacher tax credit for one year	170
Waive penalties and interest for high-risk delinquent accounts	145
<b>Total</b>	<b>\$2,425</b>

### MAJOR COMPONENTS OF AB 2065

The Omnibus Revenue and Taxation Trailer Bill includes the following changes in state tax law:

- **NOL Suspension.** Suspends the deduction of net operating loss (NOL) carryovers for tax years 2002 and 2003 under the Personal Income Tax and the Bank and Corporation Tax and extends the period of availability of these deductions by up to two years. Effective starting with NOLs incurred in 2004, this bill also increases the percentage of NOL carryovers that can be deducted in subsequent years to 100%. Currently, NOL carryover deductions are limited to 60%, but will increase to 65% for losses incurred in 2004 or later tax years.
- **Withholding for Stock Option and Bonus Income.** Increases the optional flat withholding rate for stock option and bonus income from 6% to 9.3%, effective for payments on or after January 1, 2002.
- **Bank Bad Debt Conformity.** Changes the methodology for calculating deductions for bank bad-debt losses under the Bank and Corporation Tax to conform to federal law, which limits these deductions (for banks with more than \$500 million in assets) to actual losses rather than contributions to a reserve for bad debts. Requires that banks recognize 50% of their existing bad-debt reserve balances as income in the 2002-tax year.

- **Withholding for Real Estate Sales.** Requires income tax withholding at a rate of 3 1/3% from the proceeds of the sale of real property purchased from individuals who are California residents, effective starting January 1, 2003. Currently this withholding requirement applies only to real estate sales by nonresidents. Exemptions from the withholding requirement include sales under \$100,000, sales of principal residences, sales involving losses, and like-kind exchanges. (The Franchise Tax Board has identified a cost of \$7.3 million to implement this proposal, but no additional funding was provided in the budget.)
- **Suspension of Teacher Tax Credit.** Suspends this credit for the 2002 tax year. The credit is available to credentialed teachers and varies from \$250 to \$1,500 per year, depending on length of service.
- **High-Risk Accounts.** Authorizes the Franchise Tax Board (FTB) and the State Board of Equalization (BOE) to offer to forgive any penalties, interest or fees on unpaid income tax and sales tax accounts if the outstanding tax liability is paid. This authority is limited to the period October 1, 2002 through June 30, 2003, and limited to "high-risk" accounts which either of the boards determine to be otherwise unlikely to be paid or uneconomical to collect. The budget includes 41 limited term positions at the FTB to implement this program at a cost of \$3.3 million, resulting in a net benefit of \$141.7 million.

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## Other Revenue Enhancements

Other budget actions that did not require changes in tax law increase General Fund revenues by an estimated total of \$238 million in 2002-03. These actions include the following:

- **Franchise Tax Board Collection and Enforcement**
  - **Increase Collections Staff.** Adds 130 collections staff to address tax collection accounts with an anticipated cost/benefit ratio of better than 5:1. The estimated revenue increase is \$39.1 million. (The net benefit is \$29.1 million after subtracting the \$10 million cost of the new staff.)
  - **Augment and Redirect Audit Efforts.** Adds 44.6 personnel-years (PYs) of audit staff to address workloads with an anticipated cost/benefit ratio of better than 5:1. Also redirects between 7 and 10 audit staff to focus on corporate tax credit claims, including the research and development credit and the manufacturer's investment credit. The estimated revenue increase is \$112 million. (The net benefit is \$107.5 million after subtracting the \$4.5 million cost of the new staff.)
  - **Accelerate Settlement Workload.** Adds 4 limited-term positions to work down a backlog of voluntary settlement cases. This will result in estimated revenue of \$14.1 million in 2002-03 (\$13.6 net benefit after subtracting the \$520,000 cost of the positions).
  - **Expand and Prioritize Tax Settlements.** Redirects existing resources to increase revenues by a total of \$43 million by allowing more cases into settlement (\$28 million) and by accelerating collections in 2002-03 by prioritizing cases with taxes due (\$15 million).

- **Add Staff for Large Protest Cases.** Adds 2 positions to work on tax protest cases involving more than \$5 million of tax liability. In 2002-03 this will increase revenue by \$3 million (a net benefit of \$2.7 million after subtracting \$260,000 for the cost of the positions). However, most of the estimated revenue gain will occur in 2003-04 (\$64 million), due to the lead-time needed to resolve protests.

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## Other Revenue Actions

- **Reduce Interest Paid on Overpayments.** The Omnibus General Government Budget Trailer Bills ( AB 1768 and AB 3000) reduce interest paid on overpayments of corporate taxes, estate taxes, and unclaimed property to the lower of 5 percent or the 13-week Treasury Bill rate, increasing General Fund revenue by a total of \$24 million.
- **Natural Heritage Tax Credit.** Provisions in AB 3009, a budget trailer bill, suspend for 2002-03 allocations of tax credits for donations of qualifying land or water rights under the Natural Heritage Preservation Tax Credit Act of 2000, resulting in a revenue gain of \$2.8 million.