



Date: May 8, 2017

To: Members, Senate Governance and Finance Committee

From: Peter Blocker, Legislative Advocate

**Subject: OPPOSITION to SB 567 (Lara), as amended on May 3, 2017**

The above-listed organizations are in opposition to SB 567, a tax increase that takes California out of conformity with federal tax law, prohibits the corporate income tax deduction for performance pay for the five highest paid executives, raises the charitable remainder for trusts, and increases the capital gains tax paid on inherited property. We are opposed to this bill for the following reasons:

**Timing.** Now is not the time for the state to make significant changes to the state's tax system, while Congress is debating a federal tax reform package that will have significant impacts on the way California administers its tax system and how taxpayers comply with it. California should take a cautious approach, and wait until federal tax reform is enacted before making changes to its own tax system. State Controller Betty Yee echoed the call for the Legislature to hold, so that the state can take a more informed approach when addressing the state's tax code.

**Breaks Conformity With Federal Tax Laws.** Practices prohibited by this bill will continue to be allowed under federal law, thus creating state and federal differences. SB 567 would de-conform California from federal law by disallowing a corporate income tax deduction for performance pay in excess of \$1 million to a publicly traded company's top five highest paid executives. The bill also de-conforms from federal law by requiring taxpayers who earn in excess of \$1 million to pay capital gains tax on the appreciation of inherited property. Tax conformity helps improve California's business tax climate and simplifies tax compliance, both for taxpayers and state government.

**Bad Tax Policy.** The corporate income tax is supposed to be imposed on net income. To determine net income, expenses associated with earning the income are properly deductible. Net income is defined as revenue minus costs such as raw materials, taxes, and employee compensation. SB 567 tries to undo this longstanding definition by denying deductions for certain expenses. Disallowing deductions for business expenses imposes the tax on losses by requiring taxpayers to overstate their income. Additionally, the performance pay specified by this bill still is taxed under the personal income tax by the employees who receive it.

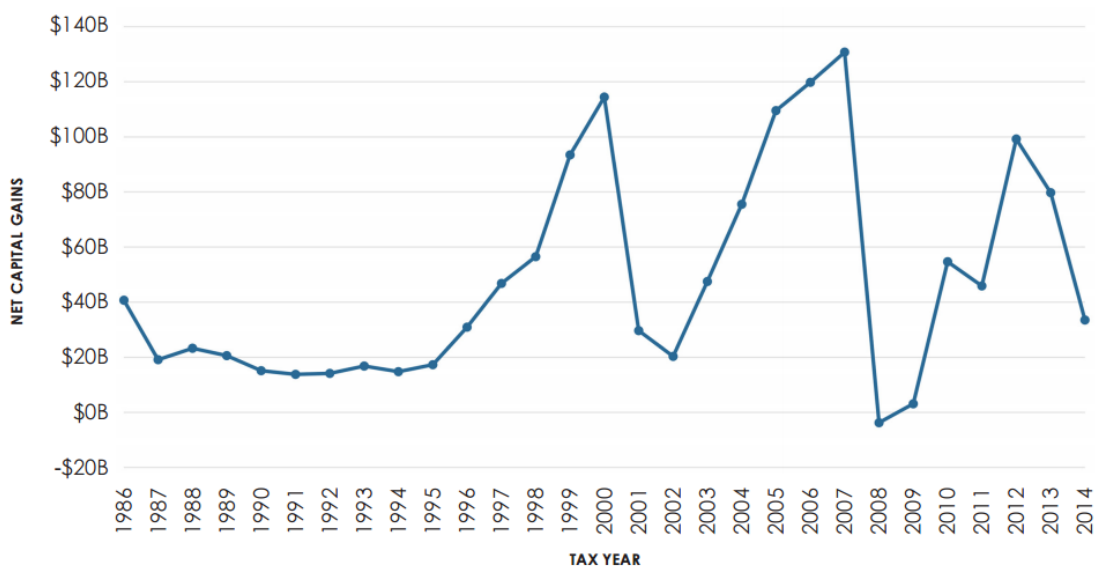
Research shows that a corporate tax increase burdens both shareholders and labor. A study by the Washington, D.C.-based Tax Foundation found that the corporate tax falls predominately on labor. Additionally, a report by the Joint Committee on Taxation, a nonpartisan committee of the U.S. Congress, found that 25 percent of the corporate tax falls to labor, with 75 percent borne by shareholders. At some point, a tax increase on large corporations ends up as a tax increase on individuals, either through less economic growth, lower wages, higher prices, fewer jobs or decreased returns in retirement accounts.

**Retroactive.** The elimination of the deduction for executive performance pay has a retroactive operative date. Taxes with retroactive operative dates run contrary to the principles of good tax policy because they make it impossible for taxpayers to properly plan to ensure they have the ability to pay.

**Income Taxes Are a Volatile Revenue Source.** The two personal income tax provisions of this bill – raising the required remainder for charitable remainder trusts and eliminating the “step-up” in basis for inherited property – would increase the state’s overreliance on its highest income earners, thus adding more volatility and uncertainty to the state’s finances.

In November 2015, State Controller Betty T. Yee released a comprehensive report on California’s tax structure, finding that California’s personal income tax is extremely volatile – largely because most of the tax (including tax on capital gains) is paid by the highest-income earners. The Commission on the 21st Century Economy came to similar conclusions in 2009.

Capital gains and losses fluctuate with the economy, creating significant cyclical swings in personal income tax revenue. The chart below shows the net gains and losses reported by personal income taxpayers since 1988.



SOURCE: FRANCHISE TAX BOARD.

According to 2016 data from the Department of Finance, more than half of California's tax and fee revenue comes from the personal income tax, and the most recent data from the Franchise Tax Board shows that the top 5 percent of earners pay 66.4 percent of the personal income tax. Most of the income reported by California's upper-income filers is related in some way to capital investments, rather than wages and salary income.

As a result of the state's disproportionate dependence on high earners, the state's revenue stream follows the boom-and-bust cycle of the stock market, as shown in the chart above from *California Tax Facts* (published by the California Tax Foundation). This volatility is in large part why Moody's Investors Service last year ranked California as the state least able to withstand a recession. This bill increases the dependence on high earners, and puts the state in an even more precarious position for the next recession.

For the foregoing reasons, the organizations listed below must oppose this legislation.

California Taxpayers Association  
Air Logistics Corporation  
Association of California Life & Health Insurance Companies  
Biotechnology Innovation Organization  
California Bankers Association  
California Business Properties Association  
California Life Sciences Association  
California Manufacturers & Technology Association  
California Tank Lines, Inc.  
Chemical Transfer, Co.  
CompTIA  
Contra Costa Taxpayers' Association  
Council on State Taxation  
Distilled Spirits Council  
Family Business Association of California  
Kern County Taxpayers Association  
National Federation of Independent Business  
Orange County Business Council  
Orange County Taxpayers Association  
San Gabriel Valley Economic Partnership  
Securities Industry and Financial Markets Association  
Solano County Taxpayers Association  
Superior Tank Wash, Inc.  
West Coast Leasing, LLC  
Western States Petroleum Association

cc: The Honorable Ricardo Lara, California State Senate