State of California

Franchise Tax Board

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California Income Tax Expenditures

Compendium of Individual Provisions

Report for 2019 Tax Year Data

Economic and Statistical Research Bureau

Contents

California Income Tax Expenditures – Taxable Year 2019

Overview

The Franchise Tax Board (FTB) first published the California Income Tax Expenditures Report in 2003. The report describes only tax expenditures found in the California corporation tax and the California personal income tax (PIT) law. We begin by discussing the concept of tax expenditures and cover many definitional and policy issues. We then present analyses of current tax expenditures within the California income tax system.

Figures 1, 2, 3 and 4 summarize the costs and policy goals of the expenditure items discussed in this report. These figures list the expenditures according to their impact on state revenue. The figure includes the cost of the expenditure and a hyperlink to additional information about the expenditure. Figure 5 lists tax expenditures by policy goal.

We organize the tax expenditures within the report in four categories: Credits, Deductions, Elections, and Exclusions; then we list the items alphabetically within each category.

Figure 1: Estimates of State Revenue for Tax Credit Items

($ In Millions - Rounded)

Tax Credit Items	Tax Year 2019 Total Number of Returns		Tax Year 2019 Revenue	Estimated Revenue by Fiscal Year		
	Personal Income Tax	Corporation		21/22	22/23	23/24
Research and Development (R&D) Expenses Credit	19,662	5,301	2,244	1,600	2,300	2,800
Dependent Exemption Credit in Excess of Personal Exemption Credit	6,081,423		1,510	1,500	1,600	1,700
Earned Income Tax Credit	3,921,223		752	700	750	800
Enterprise Zones and Similar Areas (sunset)**	3,961	3,678	436	130	95	65
Young Child Tax Credit	428,857		389	360	420	440
Senior Exemption Credit	3,128,390		328	380	400	420
Renter's Credit	2,048,070		146	150	160	170
California Competes Credit	585	164	68	80	100	120
Motion Picture Credit	14	10	61	85	140	180
Low-Income Housing Expenses Credit	190	29	27	46	55	65
Child and Dependent Care Expenses Credit	144,863		27	15	16	17
New Advanced Strategic Aircraft Program For The US Air Force Employment Credit		*	19	12	14	10
Natural Heritage Preservation Credit			15	minor	minor	minor
New Employment Credit	277	111	3	5	5	6

Tax Credit Items	Tax Year 2019 Total Number of Returns		Tax Year 2019 Revenue	Estimated Revenue by Fiscal Year		
	Personal Income Tax	Corporation		21/22	22/23	23/24
Qualified Senior Head of Household Credit	5,150		3	1	1	1
College Access Credit	429	*	3	1	1	1
Joint Custody Head of Household Credit	6,292		2	2	2	2
Blind Exemption Credit	31,403		2	2	2	3
Child Adoption Expenses Credit	1,242		2	1	1	1
Donated Fresh Fruits and Vegetables Credit	383	14	1	3	4	4
Dependent Parent Credit	2,170		1	1	1	1
Disabled Access Expenditure Credit	444	149	minor	minor	minor	minor
Enhanced Oil Recovery Costs Credit	*	*	minor	minor	minor	minor
Prison Inmate Labor Costs Credit	*	*	minor	minor	minor	minor
Transportation of Donated Agricultural Products Credit	27	*	minor	minor	minor	minor
Total (in Millions)			6,039	5,074	6,067	6,806

A minor impact is less than $500,000.
Estimates more than $500,000 and less than $50 million are rounded to the nearest $1 million.
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Estimates more than $5 billion and less than $10 billion are rounded to the nearest $500 million.
Estimates more than $10 billion are rounded to the nearest $1 billion.
* The number of returns is too small to be disclosed due to state privacy rules.
**The Enterprise Zones credit was repealed as of January 1, 2014. Qualified workers hired prior to January 1, 2014, continued to generate credits through the 2018 taxable year. Taxpayers may continue to claim carryover credits through the 2028 taxable year.

Figure 2: Estimates of State Revenue Loss for Tax Deduction Items

($ In Millions – Rounded)

Tax Deduction Items	Tax Year 2019 Total Number of Returns		Tax Year 2019 Revenue	Estimated Revenue by Fiscal Year		
	Personal Income Tax	Corporation		21/22	22/23	23/24
Mortgage Interest Deduction	4,447,203		3,901	3,700	3,900	4,100
Charitable Contribution Deduction	4,695,509	178,790	3,000	3,800	4,100	4,400
Real Property Tax Deduction	5,109,763		2,531	2,200	2,300	2,400
Individual Retirement Accounts			1,100	1,200	1,300	1,400

Tax Deduction Items	Tax Year 2019 Total Number of Returns		Tax Year 2019 Revenue	Estimated Revenue by Fiscal Year		
	Personal Income Tax	Corporation		21/22	22/23	23/24
Employee Business and Miscellaneous Expense Deduction	1,459,567		816	900	950	950
Self-Employed Retirement Plans	154,796		499	550	600	650
Depreciation Amounts Beyond Economic Depreciation			450	480	490	500
Medical and Dental Expense Deduction	1,386,453		448	430	440	440
Self-Employed Health Insurance Premium Deduction	543,811		372	370	380	390
Employee Stock Ownership Plans (ESOP)			161	220	230	250
Accelerated Depreciation of Research and Experimental Costs			138	110	100	95
Personal Property and Other Tax Deductions	4,116,121		128	120	120	120
Student Loan Interest Deduction	1,063,800		91	100	110	110
Moving Expense Deduction	104,219		15	12	12	13
Timber Growing Costs Expensing			11	13	13	13
Percentage Resource Depletion Allowance Deduction			10	10	10	10
Reforestation Expenditure Amortization			5	5	5	5
Casualty Loss Deduction	2,506		1	2	2	2
Circulation of Periodicals Cost Expensing			minor	minor	minor	minor
Allowance for Bad Debts Deduction			minor	minor	minor	minor
Total (in Millions)			13,676	14,222	15,062	15,848

A minor impact is less than $500,000.
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Estimates more than $10 billion are rounded to the nearest $1 billion.

Figure 3: Estimates of State Revenue Loss for Tax Election Items

($ In Millions – Rounded)

Tax Election Items	Tax Year 2019 Total Number of Returns		Tax Year 2019 Revenue	Estimated Revenue by Fiscal Year		
	Personal Income Tax	Corporation		21/22	22/23	23/24
Water's-Edge Election		20,101	2,642	4,200	4,400	4,800
Head of Household and Qualifying Widow(er) Filing Status	2,398,103		1,300	1,200	1,400	1,500
Tax-Exempt Status for Qualifying Corporations		196,937	158	160	170	170
Total (in Millions)			4,100	5,560	5,970	6,470

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Estimates more than $10 billion are rounded to the nearest $1 billion.

Figure 4: Estimates of State Revenue Loss for Tax Exclusion Items

($ In Millions – Rounded)

Tax Exclusion Items	Tax Year 2019 Total Number of Returns		Tax Year 2019 Revenue	Estimated Revenue by Fiscal Year		
	Personal Income Tax	Corporation		21/22	22/23	23/24
Employer Contributions to Pension Plans Exclusion			10,000	15,000	17,000	19,000
Employer Contributions to Accident and Health Plans Exclusion			7,100	8,500	9,000	9,500
Social Security Benefits Exclusion **	2,080,172		3,985	4,500	4,700	5,000
Sale of Principal Residence Capital Gain Exclusion			3,547	4,100	4,400	4,600
Basis Step-up on Inherited Property			3,275	3,500	3,600	3,700
Cafeteria Plan Benefits Exclusion			1,809	2,200	2,300	2,400
Like-Kind Exchange Capital Gain Deferral			1,208	1,100	1,100	1,100
State and Local Government Obligation Interest Exclusion			1,142	1,300	1,300	1,300
Life Insurance and Annuity Contract Proceeds Exclusion			643	650	650	650
Miscellaneous Fringe Benefits Exclusion			361	370	390	410

Tax Exclusion Items	Tax Year 2019 Total Number of Returns		Tax Year 2019 Revenue	Estimated Revenue by Fiscal Year		
	Personal Income Tax	Corporation		21/22	22/23	23/24
Transportation Related Fringe Benefit Exclusion			277	230	240	250
Federal Government Obligation Interest Exclusion	299,325		224	160	170	180
Employer Provided Meals and Lodging Exclusion			184	320	330	340
Unemployment Insurance Benefits Exclusion	900,037		167	750	190	170
Scholarship, Fellowship, and Grant Income Exclusion			162	180	190	190
Employer Contributions for Group Term Life Insurance Exclusion			158	170	170	170
Credit Union Treatment			96	120	120	120
Employee Child and Dependent Care Benefit Exclusion			91	95	95	95
Injury and Sickness Compensation Exclusion			82	85	85	90
State Lottery Winnings Exclusion	19,383		74	65	75	80
Employer Provided Education Assistance Exclusion			74	75	75	75
Nonresident Military Pay Exclusion	70,632		71	75	80	80
Cable Company Special Apportionment (Exclusion of 50% of Sales numerator)		143	59	90	95	100
Section 529 Account Interest Exclusion			58	60	70	90
Clergy Housing Exclusion			32	38	40	42
Foster Care Payment Exclusion			23	26	28	28
In Home Supportive Services (IHSS)			23	38	39	40
Limited Partnership Investment Source Rules			13	23	20	19
Intangible Drilling Costs			9	6	6	6
Agricultural Soil or Water Conservation and Prevention of Erosion Cost Expensing			5	5	5	5
Coverdell Education Savings Accounts Earnings Exclusion			5	5	5	5
Cost Share Payments by Forest Landowners Exclusion			0	minor	minor	minor
Achieving a Better Life Experience (ABLE) Act			minor	minor	minor	minor
Total (in Millions)			34,729	43,545	46,260	49,500

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Estimates more than $10 billion are rounded to the nearest $1 billion.
** Only some portions of social security income are required to be reported on federal tax returns. The number of returns reported here represents the number of Californians with social security income reported on their federal tax return. The tax impact for this exclusion includes social security income taxed for federal purposes but not taxed for California, and social security income not taxable at the federal level and not reported on the federal or California tax return.

Figure 5: Tax Expenditures by Policy Goal

Benefiting Children

- Bolstering Income for Families
    - Section 529A (ABLE) Account Interest Exclusion
    - Dependent Exemption Credit in Excess of Personal Exemption
    - Foster Care Payment Exclusion
    - Head of Household and Qualifying Widow(er) Filing Status
    - Joint Custody Head of Household Credit
    - Qualified Senior Head of Household Credit
    - Earned Income Tax Credit
    - Young Child Tax Credit
- Assistance for Nonbiological Parents
    - Child Adoption Expenses Credit
    - Foster Care Payment Exclusion
    - Qualified Senior Head of Household Credit
- Child Care Subsidies
    - Child and Dependent Care Credit (Non-Refundable Credit)
    - Employee Child and Dependent Care Benefit Exclusion
- Subsidies for Single Parents
    - Head of Household and Qualifying Widow(er) Filing Status
    - Earned Income Tax Credit
    - Young Child Tax Credit

Education

- Saving for College
    - Coverdell Education Savings Accounts Earnings Exclusion
    - Section 529 Account Interest Exclusion
- Third Party Funding for Education
    - College Access Tax Credit
    - Employer Provided Education Assistance Exclusion
    - Scholarship, Fellowship, and Grant Income Exclusion
    - Student Loan Interest Deduction

Benefiting the Elderly

- Income Subsidies
    - Senior Exemption Credit

    - Social Security Benefits Exclusion
- Subsidies for Care of the Elderly
    - Dependent Parent Credit
    - Head of Household and Qualifying Widow(er) Filing Status
    - In Home Supportive Services (IHSS)
- Subsidies for Elderly with Dependents
    - Qualified Senior Head of Household Credit

Modifying the Environment

- Land and Water Conservation
    - Agricultural Soil or Water Conservation and Prevention of Erosion Cost Expensing
    - Natural Heritage Preservation Credit
    - Reforestation Expenditure Amortization
- Reducing Air Pollution
    - Cost Share Payments by Forest Landowners Exclusion
    - Timber Growing Costs Expensing

Facilitating Employment

- Benefits for Employees Requiring Childcare
    - Child and Dependent Care Credit (Non-Refundable Credit)
    - Employee Child and Dependent Care Benefit Exclusion
- Benefits for Specific Industries
    - Cable Company Special Apportionment
    - Clergy Housing Exclusion
    - In Home Supportive Services (IHSS)
    - Motion Picture Credit
    - New Advanced Strategic Aircraft Credit
    - Nonresident Military Pay Exclusion
- Benefits for Targeted Disadvantaged Populations
    - In Home Supportive Services (IHSS)
    - Prison Inmate Labor Costs Credit
    - Earned Income Tax Credit
    - Young Child Tax Credit
- General Employment
    - California Competes Credit
    - New Employment Credit
- Transportation Subsidies
    - Moving Expense Deduction
    - Transportation Related Fringe Benefit Exclusion

Health Care

- Benefits for Assistance Providers
    - Disabled Access Expenditure Credit
    - In Home Supportive Services (IHSS)
- Benefits for Specific Medical Problems
    - Blind Exemption Credit

- Benefits for Taxpayers Who Have Incurred Major Health Related Expenses
  - Section 529A (ABLE) Account Interest Exclusion
  - Injury and Sickness Compensation Exclusion
  - Medical and Dental Expense Deduction
- Insurance Purchase Subsidies
  - Cafeteria Plan Benefits Exclusion
  - Employer Contributions to Accident and Health Plans Exclusion
  - Self-Employed Health Insurance Premium Deduction

Housing

- Benefits for Homeowners
  - Mortgage Interest Deduction
  - Real Property Tax Deduction
  - Sale of Principal Residence Capital Gain Exclusion
- Benefits for Rental Housing
  - Low-Income Housing Expenses Credit
  - Renter's Credit (Nonrefundable Credit)
  - Clergy Housing Exclusion

Finance

- Rules for Alternative Business Ownership Structures
  - Credit Union Treatment
  - Employee Stock Ownership Plans (ESOP)
  - Limited Partnership Investment Source Rules
- Special Rules for Banking
  - Allowance for Bad Debts Deduction
  - Credit Union Treatment
- Other Finance Provisions
  - Like-Kind Exchange Capital Gain Deferral

Business Investments

- Depreciation
  - Accelerated Depreciation of Research and Experimental Costs
  - Agricultural Soil or Water Conservation and Prevention of Erosion Cost Expensing
  - Circulation of Periodicals Cost Expensing
  - Depreciation Amounts Beyond Economic Depreciation
  - Expensing of Intangible Drilling and Development Costs
  - Timber Growing Cost Expensing
- Equipment and Infrastructure
  - Disabled Access Expenditure Credit
  - Enhanced Oil Recovery Costs Credit
  - Expensing of Intangible Drilling and Development Costs
- Preferential Treatment for Small Businesses
  - Allowance for Bad Debts Deduction
- Research and Development
  - Accelerated Depreciation of Research and Experimental Costs

    - Research and Development (R&D) Expenses Credit
- Subsidies for the Petroleum Industry
    - Enhanced Oil Recovery Costs Credit
    - Expensing of Intangible Drilling and Development Costs
    - Percentage Resource Depletion Allowance Deduction
- Subsidies for Other Specific Industries
    - Cable Company Special Apportionment
    - Circulation of Periodicals Cost Expensing
    - Donated Fresh Fruits and Vegetables Credit
    - Low-Income Housing Expenses Credit
    - Motion Picture Credit
    - New Advanced Strategic Aircraft Credit
- Other
    - Like-Kind Exchange Capital Gain Deferral

Employer Provided Benefits

- Childcare Benefits
    - Cafeteria Plan Benefits Exclusion
    - Employee Child and Dependent Care Benefit Exclusions
- Employee Housing
    - Clergy Housing Exclusion
    - Employer Provided Meals and Lodging Exclusion
- Insurance
    - Cafeteria Plan Benefits Exclusion
    - Employer Contributions for Group Term Life Insurance Exclusion
    - Employer Contributions to Accident and Health Plans Exclusion
    - Self-Employed Health Insurance Premium Deduction
- Pension Plans
    - Employer Contributions to Pension Plans Exclusion
    - Self-Employed Retirement Plans
- Transportation Subsidies
    - Employee Business and Miscellaneous Expense Deduction
    - Miscellaneous Fringe Benefits Exclusion
    - Transportation Related Fringe Benefit Exclusion
- Other Employer Provided Benefits
    - Employee Business and Miscellaneous Expense Deduction
    - Employer Provided Education Assistance Exclusion
    - Miscellaneous Fringe Benefits Exclusion

Encouraging Savings

- College
    - Coverdell Education Savings Accounts Earnings Exclusion
    - Section 529 Account Interest Exclusion
- Retirement
    - Employer Contributions to Pension Plans Exclusion
    - Individual Retirement Accounts

- Self-Employed Retirement Plans

Capital Gains

- Basis Step-Up on Inherited Property
- Like-Kind Exchange Capital Gain Deferral
- Sale of Principal Residence Capital Gain Exclusion

Government Programs

- Government Payments Not Taxed
  - Federal Government Obligation Interest Exclusion
  - In Home Supportive Services (IHSS)
  - Scholarship, Fellowship, and Grant Income Exclusion
  - Social Security Benefits Exclusion
  - State and Local Government Obligation Interest Exclusion
  - State Lottery Winnings Exclusion
  - Unemployment Insurance Benefits Exclusion
  - Nonresident Military Pay Exclusion
  - Personal Property and Other Tax Deductions

Catastrophes

- Life Insurance
  - Employer Contributions for Group Term Life Insurance Exclusion
  - Life Insurance and Annuity Contract Proceeds Exclusion
- Other Catastrophes
  - Casualty Loss Deduction

Definition of Corporate Income

- General Structure of Corporate Taxation
  - Cable Company Special Apportionment
  - Water's-Edge Election
- Nonprofit Activities
  - Charitable Contribution Deduction
  - Credit Union Treatment
  - Donated Fresh Fruits and Vegetables Credit
  - Tax-Exempt Status for Qualifying Corporations
  - Transportation of Donated Agricultural Products Credit

Section 1: The Concept of Tax Expenditures

Tax Expenditures are Deviations from Normal Tax Law

Tax expenditures, as defined by federal law, are "revenue losses attributable to provisions of the federal tax laws that allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." According to the federal Joint Committee on Taxation (JCT), the legislative history of this definition indicates that tax expenditures are to be defined with respect to a "normal income tax structure." This same concept of tax code provisions which reduce tax relative to normal tax law can be applied to California tax law. We explore the concept of normal California tax law below.

The term tax expenditures alludes to the fact that the policy objectives could be achieved by means other than tax provisions. Rather than reducing beneficiaries' taxes, the Legislature could, for example, establish direct expenditure programs to allocate money toward its policy goals.

Normal Tax Law

Conceptually, a broad definition of income should be used in determining the normal tax law against which tax expenditures are to be measured. Using the broadest possible definition of income generally makes for sound tax policy, because the broader the base, the lower the tax rate needed to achieve a desired level of revenues, and lower tax rates produce less economic distortion.

Following the JCT methodology, our report assumes the existing tax rate structure is part of normal tax law, even though the tax rates vary for different levels of income. The JCT methodology includes the zero percent tax bracket as part of normal PIT Law. The zero bracket is the maximum amount of income that a taxpayer, who has no extraordinary deductions or credits, can earn and still owe no taxes. This maximum amount is determined by the standard deduction, the personal exemption credits for each taxpayer, and a dependent exemption credit for each dependent. These items of normal tax law are not classified as tax expenditures. Itemized deductions that are not necessary for the generation of income are considered to be tax expenditures,[1] but only to the extent that they exceed the standard deduction. Most other tax benefits to individual taxpayers are considered tax expenditures.

In defining normal income for businesses, some difficult issues arise. Businesses routinely invest in property and equipment that lasts a long time. These costs should be depreciated (i.e., the tax deductions for these investments should be spread over the useful life of the investment). JCT has generally considered the Alternative Depreciation System as the method of depreciation most representative of normal tax law. Alternatives that provide more favorable treatment of capital expenses, including accelerated depreciation, expensing, and investment tax credits, are considered tax expenditures. JCT also assumes that normal tax law requires the accrual method of accounting, use of the "economic performance" standard for testing whether liabilities are deductible, and requires a general concept of matching income and expenses. Provisions not satisfying these three standards are considered tax expenditures. JCT considers net operating loss carrybacks and carryforwards to be part of normal tax law.

Provisions in the tax code that generate less favorable treatment than normal tax law (as defined above) have not traditionally been considered to be tax expenditures. Similarly, the Alternative Minimum Tax (AMT) and passive activity loss rules, which reduce the value of many other tax expenditures, are not considered tax expenditures. The interaction of AMT and passive loss rules are, however, considered in computing the costs of other tax expenditures.

Adoption and Retention of Tax Expenditures

While each tax expenditure has its own set of reasons for having been adopted (many of which will be explored in the next section), a number of policy considerations are common to many tax expenditures.

There are two primary policy motivations for adopting tax expenditures. The first is to move towards a more equitable tax system by providing relief to taxpayers facing a monetary cost due to their

[1] Deductions that are necessary for the generation of income include those for investments and for employee business expenses.

circumstances in life. The second is to provide taxpayers with incentives to alter their behavior.

In addition to these policy goals, decisions to adopt certain tax expenditures may also be driven by administrative concerns. These concerns may include restrictions imposed by the federal government, the desire to keep state tax law in conformity with federal tax law, and other miscellaneous administrative issues.

Proper analysis of tax expenditure policies must consider their potential adverse effects as well as their desirable effects. The most common concerns arising from the use of tax expenditures are that they may:

- Necessitate an increase in tax rates (or, alternatively, cuts in government spending).
- Complicate the tax code.
- Induce undesirable behavioral reactions from taxpayers.
- Provide expensive windfalls to some taxpayers without furthering the intended policy goals.
- Reduce policy flexibility.

Finally, a complete analysis of the desirability of a particular tax expenditure requires consideration of possible policy alternatives for achieving the same goal. These alternatives include:

- Reducing general tax rates.
- Government mandates.
- Direct government regulations.
- Direct expenditures.
- Modifying tax expenditures.

In the balance of this section, we explore these considerations in more detail.

Policy Motivations

Equity

Many tax expenditures are designed to provide tax relief to taxpayers who face specific and unusual monetary costs. This type of tax expenditure enables taxes to be levied on a more accurate measure of a taxpayer's economic well-being. Under certain circumstances, other issues besides the dollar amount of income earned, marital status, number of dependents, and standard deduction must be considered to accurately measure a taxpayer's economic well-being. Tax expenditures of this type are available to any taxpayer whose life circumstances fall into the designated category. One such example is the additional credit for taxpayers (or their spouses)[2] who are blind. The credit for the blind is intended to restore equity by compensating taxpayers for expenses incurred specifically because they are blind.

Behavioral Incentives

Other tax expenditures are designed by the Legislature to provide incentives for taxpayers to modify their behavior. This type of expenditure necessarily moves the tax system away from the theoretically desirable goal of neutrality. "Neutrality" is the concept that a tax system should have as little impact on the allocation of resources as possible. In other words, under a neutral tax system, economic agents should make the same decisions as if there were no tax system and their decisions were motivated solely by the marketplace incentives.

Deviations from neutrality are not necessarily bad policies. Most economists would argue that there are many examples of neutral outcomes that are not optimal. For example, when deciding whether to carpool or drive to work alone, a taxpayer may consider such things as the cost of gas, the wear and tear on their car, the mental stress of driving, the hassle of coordinating their schedule with other commuters, and their dependence on other commuters. It is possible, and perhaps likely, that they will not sufficiently take into account the benefits that they are providing to others who commute along their commute route when they carpool - one less car on the road. In so doing, it is possible that their decision will not be optimal. They

[2] For purposes of California income tax, references to a spouse, a husband, or a wife also refer to a registered domestic partner (RDP), unless otherwise specified.

will consider all of the private costs and benefits of carpooling, but will (most likely) insufficiently consider the public costs and benefits. As such, a decision to carpool will be made less often than would be socially optimal. Thus, a credit for carpooling will allow the person who chooses carpooling to reap some of the social benefit of carpooling. This will increase the likelihood of a decision to carpool. In such a situation, if the net social benefit from carpooling is positive, the fact that the tax system alters private decisions (or violates tax neutrality) is actually good. Policymakers must be careful, however, to ensure both that tax incentives induce desired behaviors and that they do not induce too much of the desired behaviors.[3]

The effectiveness of behavioral incentives depends on what economists refer to as "price elasticity." Each tax preference reduces the relative price of the favored activity (in the above example, the credit slightly lowers the cost of commuting to the taxpayer). Just as some department store sales are more successful than others, a small drop in after-tax prices will sometimes cause many taxpayers to alter their behavior, but other times it will not. The elasticity is the magnitude of the behavioral reaction to a particular change in prices.

Administrative Issues

Federal Preclusion

Some tax expenditures were established by federal mandate. An example of this is the requirement that California exempt interest earned on federal savings bonds from taxable income, if interest earned on state savings bonds is exempt. California does not have the authority to modify tax expenditures imposed by the federal government.

Conformity

Many California tax expenditures are identical to provisions found in federal tax law. Conformity to certain federal tax provisions can reduce complexity by allowing taxpayers to use the same calculations for both their federal and state tax returns. It also reduces administrative costs by enabling California to rely on information exchanges with the Internal Revenue Service (IRS) to verify substantial portions of Californians' tax returns in lieu of developing more expensive independent audit capacity.[4]

Ending conformity between California and federal tax law would be particularly costly for any tax expenditures that take the form of exclusions that are not currently reported on tax forms. For example, both California and the federal government exclude employer contributions to pension plans from employee income. If California eliminated this tax expenditure, employers would need to develop systems for reporting the amount of these contributions made on behalf of each individual taxpayer to FTB and the taxpayer. FTB would need to educate taxpayers to include this extra information on their California tax returns, modify tax forms to include this item in income, develop an audit system for collecting contribution information from employers, and match this data to individual tax returns.

The costs of ending conformity with federal tax law would be lower for many tax expenditures that involve adjustments to income, such as deductions that are already reported on tax forms. For example, if California wanted to eliminate the deduction for medical and dental expenses, much of the effort required to eliminate the exclusion of pension income would be avoided. In this case, California would need to modify its tax forms and/or instructions so that taxpayers could back out the medical and dental expense deductions they claimed on their federal returns. FTB would also have to implement a relatively simple modification to its audit tools to check that the amount of the medical and dental expense deduction is backed out of California itemized deductions. The costs from eliminating this deduction would be substantially smaller than the costs described above for eliminating an exclusion.

Conformity does not justify the existence of a state tax credit, even when the tax credit calculation conforms to federal law. California could simply eliminate any credit and there would be no increase in compliance costs. When we do adopt a credit that is similar to a federal credit, it is good policy for us to

[3] In the carpool credit example, suppose we need 10,000 new carpools to relieve congestion and pollution. It would be inefficient to set the credit so high that 50,000 new carpools are formed.

[4] Another benefit of conformity, which is psychological rather than economically substantive, is that taxpayers may feel entitled to all deductions and exclusions available in federal tax law. Even if a tax expenditure is not justifiable on policy grounds, taxpayers may feel it is unfair for state taxable income to be greater than federal taxable income.

conform to the federal definition of qualifying circumstances and the federal calculation of the amount of activity qualified to receive a credit. However, there is no reason to argue for the adoption or retention of a credit solely on conformity grounds. Whether a credit should be adopted or retained should be decided solely on the credit's policy merits, without considering conformity.

It may appear that since the federal government is already providing tax benefits for conformity items, there is no reason for the state to provide additional benefits. In fact, conformity can be justified for many tax expenditures. For example, it makes sense for the state to conform to tax expenditures, such as the deduction for medical and dental expenses, which are designed to provide hardship relief to a class of taxpayers. This is because the condition that impedes the taxpayers' capacity for paying federal taxes will also impede their ability to pay state taxes.

Conformity analysis is more complicated for tax expenditures whose primary purpose is to provide incentives to alter taxpayer behavior. State level behavioral incentives have two effects. The first is that they encourage more tax-favored behavior. For example, state level tax preferences for Individual Retirement Accounts (IRAs) will induce increased contributions to these accounts. Whether or not this is a good thing depends on whether the federal government has already provided an optimal incentive for this behavior. If the federal incentive is not strong enough to induce the optimal level of contributions to these accounts, the additional state incentive will encourage a more productive allocation of savings. If, on the other hand, the federal incentive by itself stimulates sufficient savings, additional state incentives will cause too much savings in these accounts, leading to economic inefficiencies.

The second effect of state level behavioral incentives is to encourage taxpayers to engage in tax-favored activities in California. For example, special treatment of research and development expenditures may induce firms to conduct research in California rather than elsewhere. Again, depending on other factors in the economy, this may be beneficial to California, or it may cause an inefficient distortion of investment decisions.

Other Administrative Issues

Conceptually, the income tax base should include many types of imputed income, as well as, income received through cash transfers. An example is the implicit income from owner-occupied housing. Consider two houses identical in every way except that the first is a rental and the second is owner-occupied. The owner of the first house provides something of value to the renters. In return, the renters pay rent. This rent is taxable income to the landlord. The occupants of the second house receive the same benefits (the use of an identical house) as the occupants of the first house. Conceptually, the difference between the rent that they should have paid and the rent they actually paid (zero) is a benefit that should be included in taxable income. This could be done by calculating the income that the owners of the second house would have earned if someone else were renting that house and included that in their income. As a practical matter of course, this calculation would be extremely difficult, so we often choose not to tax imputed income. In fact, it would be so difficult that JCT describes this problem as an "administrative necessity" and does not report it as a tax expenditure.

Another area in which administrative practicality plays a large role is capital gains. Conceptually, capital gains taxes should be levied on an accrual, rather than a realization basis. Theoretically, taxpayers should include in income the amount by which their investments appreciate during the tax year.[5] For many investments, it is difficult to determine the value of this appreciation in years in which the asset is not sold. Therefore, it is much simpler to wait until the asset is sold and tax the entire amount of appreciation, since purchase, at one time. Since investors will not report all of their gains in any year in which they do not sell all of their assets, this system generates tax expenditures.

Disadvantages of Tax Expenditures

Increases in General Tax Rates

[5] The justification for this position is derived from the concept that a proper income tax should be levied on Haig-Simons income. Haig-Simons income is defined for a particular time period as all consumption plus any additions to net wealth during that time period. The classic references are H.C. Simons, *Personal Income Taxation,* (Chicago: University of Chicago Press, 1938); and R.M. Haig, "The Concept of Income: Economic and Legal Aspects," in R.M. Haig, ed., *The Federal Income Tax*, (New York, Columbia University Press, 1921).

By definition, tax expenditures are deviations from normal tax law that reduce the amount of tax paid by the affected taxpayer. If a government has a fixed level of revenue that it must raise to fund its programs and operations, any revenue forgone through tax expenditures must be raised elsewhere in the tax system. This means that the government must either find a new source of revenue or raise rates for some existing taxes. Raising tax rates generally is bad for the economy because it increases the distortional impact of taxes on economic decision-making. Therefore, tax expenditures should not be adopted unless their benefits outweigh the costs to the economy from compensating tax increases. For example, in 2019 if we had eliminated one large PIT tax expenditure, the mortgage interest deduction, we could have lowered PIT tax rates by approximately 4 percent across the board and still raised the same amount of revenue. Similarly, in 2019 if we had eliminated the largest corporate tax credit, the Research and Development (R&D) credit, we could have lowered the corporate tax rate by approximately 20 percent and still raised the same amount of revenue.

Complexity of the Tax Code

Many tax expenditures increase the complexity of the tax code. Each deduction and credit requires its own calculation. The additional computational complexity is exacerbated by interactions with the Alternative Minimum Tax (AMT). AMT prevents certain taxpayers from using all of their deductions and credits in the current year. Thus, a taxpayer may be required to make not one, but three, new calculations – one for the tax expenditure itself, a second for the AMT, and a third in the future tax year in which they apply their carryover AMT credit. In addition to the calculations themselves, many tax expenditures require the generation and retention of copious paperwork to prove their validity at audit. Each provision also necessitates additional training and workload for tax auditors. These administrative considerations could potentially outweigh the benefits of some of the less valuable tax expenditures.

Undesirable Behavioral Effects

Tax expenditures are often adopted because the Legislature hopes that their incentives will alter the behavior of taxpayers. This runs counter to a general principle of tax policy called neutrality. This tenet holds that inefficient distortions to the economy usually result when different activities face different taxes. In the case of tax expenditures, we know that the Legislature is trying to compensate for what it perceives as a failure of the free market to provide sufficient incentives for certain activities; therefore, these distortions may be justified. However, it is very difficult to know if a tax expenditure has been calibrated properly for achieving its desired goal. For example, if a tax credit intended to encourage additional investments of a specific type is set too high, the credit may have the effect of diverting investment from other projects that would be more beneficial to the economy. Another possibility is that a tax expenditure may be adopted on equity grounds to offset some cost peculiar to a particular group of taxpayers, but it may also induce behavioral changes. For example, the Renter's Credit was designed to offset the perceived inequities in tax treatment between renters and homeowners. However, the Renter's Credit actually offers renters an incentive to continue renting their home rather than buying it. As a result, this credit undermines the mortgage interest deduction and other tax expenditures that were designed specifically to encourage home ownership.

Windfalls

Tax expenditures are very blunt policy instruments. They are available to broadly defined groups of taxpayers. For this reason, they often provide taxpayers generous rewards without furthering the policy goals for which they were intended. These windfalls are most noticeable with tax expenditures whose primary motive is to provide behavioral incentives. For example, cable companies may use special apportionment rules to reduce their taxes even though they likely would have continued to invest in their systems and serve their customers even in the absence of the special rules.

The presence of windfalls can dramatically increase the costs of a tax expenditure relative to its benefits. For example, suppose that an investment credit of 5 percent induces a 10 percent increase in private investments. A firm that previously invested $100 now invests $110. The firm claims a credit of $5.50 ($110 x 5 percent). The credit costs the government 55 percent of the increase in investment ($5.50 credit / $10 increase in investment), not the 5 percent nominal value of the credit. In this example, policymakers should only adopt such a credit if the positive externalities generated from the increased investment are worth at least 55 percent of the investment.

Reduced Policy Flexibility

We argued above that tax expenditures are analogous to direct government expenditures. However, the two types of expenditures are treated differently under the Constitution of the State of California. If the Legislature decides that a direct expenditure has not worked out as planned, or has become obsolete, it may be amended or revoked with a simple majority vote. By contrast, it requires a two-thirds vote of the Legislature to undo a failed or obsolete tax expenditure. This super-majority requirement may make it more difficult to amend or abandon tax expenditures that fail to accomplish their policy goals.

Alternatives to Tax Expenditures

There are a variety of other policy instruments available for achieving the policy goals underlying various tax incentives. The next section of this report discusses a number of relevant policy alternatives for specific tax expenditures. Here we describe the broad categories into which these alternatives may be classified.

One alternative that may be considered for any tax expenditure whose goal is to improve the economy in general would be to eliminate the tax expenditure and instead reduce tax rates.

For tax expenditures aimed at spurring investment in specific activities, industries, or geographic locations, alternatives include direct government loans, direct government loan guarantees, or rate subsidies supporting the desired class of projects.

Some policy objectives can be achieved through government mandates, requiring businesses to participate in achieving certain policy goals. For example, the Low-Income Housing Expenses Credit could be replaced with requirements that lenders or developers divert a portion of their economic activity to the low-income market.

Almost any tax expenditure program could simply be replaced with a direct expenditure program. This is most obvious in the case of credits. For example, instead of offering a Child Adoption Expense Credit, California could make direct payments, equivalent to the tax savings available under the credit, to individuals who adopt children that are in the custody of a government agency. Replacing nonrefundable credits with a direct expenditure program would likely increase costs to the state. Costs would increase by the amount of credits that taxpayers were unable to apply because they had no remaining tax liability to offset.

Other forms of tax expenditures also can be replaced with direct expenditures, but may be more difficult to administer. For example, the itemized deduction for medical and dental expenses in excess of 7.5 percent of adjusted gross income could be replaced with direct payments to individuals with these expenses. The administrative problem is that the value of this deduction may vary across taxpayers, even if the amount of their deduction is the same. Suppose two taxpayers are each entitled to a deduction of $2,000 for these expenses. Taxpayer A is in the 6 percent marginal tax bracket, so her tax savings is $120. Taxpayer B is in the 4 percent tax bracket, so he saves $80. Any direct expenditure that provides the same benefit to these two individuals (on the grounds that they had identical qualifying expenses) would result in a redistribution of income relative to the current deduction. A program that attempts to replicate the impact of the deduction by granting different benefits to taxpayers at different income levels could be more difficult to administer.

Tax expenditures may also be easier to administer than direct expenditures simply because the bureaucratic structure of FTB is already in place. Creating a new agency or a new program within an existing agency to administer a new direct expenditure program could be less efficient than using the existing tax expenditure apparatus.

Another general administrative problem with direct expenditures is that losses from fraud may be greater with direct expenditures than with tax expenditures (other than refundable credits). This is because the number of fraudulent claims for a tax expenditure is limited to the number of taxpayers who have tax liabilities to reduce. With direct expenditures, on the other hand, people without tax liabilities to reduce can apply fraudulently for the benefit, and individuals can more easily submit multiple claims for the same benefit.

Finally, we note that some tax expenditures could be altered to more precisely achieve their policy goals at lower cost. For example, if the primary goal of the mortgage interest deduction is to increase the percentage of taxpayers who own their own home, it might make more sense to give a large tax credit to taxpayers who are purchasing their first home, rather than the current deduction that is most valuable to taxpayers who already own homes, but are moving to much bigger and more expensive ones.

Conceptual Summary

In general, the best tax systems apply low tax rates to a broad tax base. However, some public policy objectives can be achieved by violating this principle. When elements of the tax base receive preferential treatment, we refer to the treatment as a tax expenditure.

The most common types of tax expenditures are:

- Exclusions of certain types of income from tax.
- Deductions from income.
- Tax credits.

Reasons for granting tax expenditures include:

- The desire to offset monetary costs faced by certain classes of taxpayers.
- The desire to provide incentives to alter taxpayer behavior.
- Federal limitation on state tax systems.
- Conformity issues.
- Administrative simplicity.

Adverse consequences of tax expenditures include:

- Higher tax rates on income not receiving preferential treatment.
- Increases in the complexity of the tax code.
- Undesirable behavioral responses by taxpayers taking advantage of preferential treatments.
- Windfall payments from the government to taxpayers who would have undertaken desired activities even in the absence of tax incentives.
- Reduced policy flexibility.

There are potentially many good reasons for using tax expenditures within a tax system. However, policymakers should give careful thought to the reasons why the tax expenditure is needed, and the potential adverse consequences of adopting or retaining the tax expenditure. The pros and cons of each tax expenditure should be weighed as carefully as the pros and cons of any regular government expenditure program.

Section 2: Analysis of Tax Expenditures

This section provides more in-depth analysis of many of the tax expenditures that are currently part of California income tax law.

The analysis below presents estimates of each tax expenditure's revenue cost and the number of taxpayers who benefit from them. Each description identifies whether or not the tax expenditure conforms to federal income tax law. For several of the more significant tax expenditures, we present a distributional analysis of the taxpayers claiming the tax expenditure.

Tax expenditure estimates are more reliable for some expenditure items than for others. The most reliable estimates are for credits. For these tax expenditures, we present actual amounts of credit claimed in 2019. Estimates for deductions are also generally reliable, since deductions must be reported on tax returns. Since the amount of deduction claimed by each taxpayer is known, we can calculate, for each taxpayer in our statistical sample, how much tax they would have owed if the deduction were not available. The revenue effects of exclusions and exemptions, on the other hand, are very difficult to estimate. We often do not have data on the actual amount of potential income that taxpayers are not required to report, so we cannot simulate the effects of these tax expenditures directly from tax data. As a result, these estimates are less reliable.

The estimates we present do not consider any changes that might occur in the overall performance of the California economy if the tax expenditure were removed.

Tax expenditure estimates are not the same as estimates of the revenue impact of repealing a tax expenditure item. Of course, for many expenditure items, the difference between these two estimates will be minimal or even nil. For example, the estimates of the senior exemption would be the same for a tax expenditure estimate and for a repeal revenue estimate. For other tax expenditures, however, there can be dramatic differences between the expenditure estimate and the repeal revenue estimate.[6]

One major source of difference between expenditure and repeal revenue estimates is the assumption that there are no interactions between tax expenditures. This assumption is consistent with the way government expenditures are typically presented. For example, when presenting the budget-year cost of the California State University (CSU) system, the Governor’s Budget only considers the actual amount spent on the university system. It does not consider that, if the CSU system were eliminated, the community college system would face greater costs because of higher enrollment. Offsets that would arise if a particular expenditure item were eliminated are not considered in the budgeting for expenditure items.[7]

Where interactions between tax expenditures exist, the actual revenue impact of eliminating a single tax expenditure item may differ from the cost reported below. The direction of the bias in the estimates presented below will depend on whether the expenditures are complements or substitutes. Complementary tax expenditures increase each other’s value. For example, many analysts believe that if the mortgage interest deduction were eliminated, many homes would decrease in value. A drop in home prices would reduce the property taxes owed on the houses and, in turn, the amount of property tax deductions for income tax purposes. Therefore, the actual revenue impact of removing the mortgage deduction would be equal to the direct impact estimated for that tax expenditure, plus the impact of the resulting reduction in tax expenditures for property tax deductions.

When tax expenditures are substitutes, the revenue effects of eliminating a single expenditure will likely be less than the estimates presented below. For instance, if the exclusion of earnings from IRC Section 529 education plans were eliminated, much of the money in these plans would likely be diverted to Coverdell Education Individual Savings Accounts. The actual revenue effect of eliminating the Section

[6] For many types of tax expenditures revenue estimates of tax expenditure repeals are more reliable than revenue estimates for the introduction of new tax expenditures. This is because the current tax expenditure includes information on many of the behavioral responses that vex revenue estimators. For example, to do a revenue estimate for the introduction of a new manufacturer’s investment credit, the estimator must (among other things) estimate the amount of new investment in manufacturing that will only occur because of the presence of the credit. This is not an issue for estimating the effect of repealing such a credit, because the current credit totals include both credits claimed for investments that would have occurred anyway and credits claimed for new investments that would not have occurred without the credit.

[7] These offsetting costs would likely be considered if there were a legislative proposal to eliminate the CSU system.

529 tax expenditure would then be equal to the cost estimated, minus the resulting increase in the cost of the Coverdell tax expenditure.

Another cause of differences between expenditure estimates and repeal revenue estimates is that some tax expenditures accumulate over time. For example, the estimate for the basis step-up for inherited capital gains differs dramatically between a tax expenditure estimate and a legislative repeal estimate. The reason is that if the basis step-up were repealed, the law change would only apply to those assets inherited after the legislation's effective date. If property is inherited, it may be sold the year it is inherited, the next year, or any other year after that (or potentially never). Thus, in the first year, the repeal would be effective only for the inherited assets that were inherited in that year and sold in that year. In the second year for which the repeal is effective, both assets inherited and sold in that year and assets inherited in the prior year and sold in that year would be affected. Therefore, while in the first year only one "vintage" of inherited assets will be affected, in the second year two "vintages" of inherited assets will be affected.[8] In each subsequent year, an additional vintage of inherited assets will be added to the group of affected assets. Thus, the revenue estimate for repeal would show steady growth over the first several years. For the tax expenditure concept, however, we would estimate the impact if all inherited property that was sold in a particular year did not have the basis step-up, regardless of when it was inherited. Thus, our tax expenditure estimate of the basis step-up is approximately $3.4 billion for the fiscal year 2020/2021, while the estimated revenue gain from repeal of the basis step-up is only $100 million in the first year.

Following the revenue estimate for each tax expenditure is an overview of policy considerations that may be relevant to that tax expenditure. This overview includes a brief summary of the intent of the tax expenditure, some discussion of the conditions under which the tax expenditure should be viewed as a successful policy tool and, where appropriate, a discussion of potential policy alternatives for achieving the tax expenditure's policy goal.

[8] Vintage, in this sense, refers to all the assets inherited in a particular year.

Credit Expenditure Items

Blind Exemption Credit

Description:

This program allows a taxpayer to claim an additional personal exemption tax credit if either the taxpayer or the taxpayer's spouse is blind (two credits may be claimed if both are blind). Each additional personal exemption credit (adjusted annually for inflation based on the California Consumer Price Index) was $122 in 2019, $124 in 2020, and $129 in 2021.

There is no comparable federal credit. However, federal law does allow an additional deduction for these individuals as explained below.

Amount:

In tax year 2019, taxpayers claimed $3.9 million in blind exemption credits, reducing their taxes by about $2 million.

Number of Tax Returns Affected:

In tax year 2019, 31,000 PIT returns included this credit.

Distribution:

Blind Exemption Credit: 2019

Adjusted Gross Income Class	Returns Reporting Credit	Amount of Credit Claimed (Thousands)	Tax Impact of Credit (Thousands)
Less than $10,000	4,051	$500.8	$256.4
$10,000 to $19,999	3,658	$451.8	$231.3
$20,000 to $49,999	8,614	$1,067.9	$546.8
$50,000 to $99,999	7,964	$995.4	$509.7
$100,000 to $199,999	4,977	$622.0	$318.5
More than $199,999	2,139	$266.0	$136.2
Total	31,403	$3,903.8	$1,998.9

Source: 2019 Personal Income Tax Population File and Microsimulation Model
Detail may not add to total due to rounding.

Discussion:

This exemption is intended to compensate taxpayers who have increased expenses because they are blind.

Federal law provides an additional deduction from adjusted gross income for blind taxpayers who do not itemized their deductions. The amount of this deduction is $1,300 for married taxpayers (whether filing separately or jointly) and surviving spouses and $1,650 for single taxpayers and head of household filers. The federal deduction is more consistent with the concept that income spent on blindness-related expenses should not be considered in calculating an individual's ability to pay taxes. Because of California's highly progressive tax rate structure, a credit provides more tax benefit than a deduction to lower-income taxpayers.

This credit is effective at reducing the tax liability of blind taxpayers. It is unclear why the Legislature believes that the blind require more assistance than do taxpayers with other types of disabilities, or why a taxpayer should receive the credit if their spouse is blind, but not if another dependent is blind. As with all similar credits, a direct expenditure program to benefit the blind would be an alternative to this credit.

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California Competes Credit

Description:

The California Competes Credit provides a credit to businesses who want to locate or stay and grow in California. Taxpayers may only claim credits authorized in agreements between the taxpayer and the Governor's Office of Business and Economic Development (GO-Biz). The amount of the credit available to a taxpayer for a taxable year is negotiated and set forth in a written agreement between GO-Biz and a taxpayer. As a result, there is a lag between the allocation of the credit and the usage of the credit. GO-Biz is authorized to allocate California Competes Credits for fiscal years 2013-14 through 2027-28. The credit became available beginning in taxable year 2014 and may be claimed through the 2030 taxable year.

The amount of the credit is based on several factors intended to reflect the economic impact of the agreement on the state such as: the number of full-time jobs created or retained in California, the amount of compensation paid to employees, and the amount of investment within the state. As part of the credit agreements, businesses must commit to certain employment or project investment requirements (milestones) in California.

There is no comparable federal credit.

Amount:

In tax year 2019, credits in the amount of $12 million on PIT returns and $56 million on corporation tax returns were allowed.

Number of Tax Returns Affected:

In tax year 2019, 585 PIT returns and 162 corporate tax returns claimed these credits.

Distribution:

California Competes Credit: 2019

Adjusted Gross Income Class*	Returns Claiming Credit	Returns Allowing Credit	Amount of Credit Claimed (Thousands)	Amount of Credit Allowed (Thousands)
Less than $19,999	15	15	$511.6	$511.6
$20,000 to $49,999	10	10	$3.2	$3.2
$50,000 to $99,999	30	30	$21.5	$21.5
$100,000 to $199,999	81	81	$307.7	$307.7
More than $199,999	447	447	$11,007.0	$11,007.0
Total	585	585	$11,851.2	$11,851.2

Source: 2019 Personal Income Tax Population File
Detail may not add to total due to rounding.

California Competes Credit (Corporations): 2019				
Size of Gross Receipts	Returns Claiming Credit	Returns Allowing Credit	Amount of Credit Claimed (Thousands)	Amount of Credit Allowed (Thousands)
Less than $1 million	23	21	$54.4	$52.4
$1 million to $5 million	31	31	$139.7	$139.7
$5 million to $25 million	40	38	$582.0	$465.6
$25 million to $100 million	30	28	$1,839.2	$1,788.2
$100 million to $500 million	26	26	$3,888.3	$3,888.3
Greater than $500 million	20	20	$49,434.1	$49,434.1
Total	170	164	$55,937.7	$55,768.3

Source: 2019 BETS Extract

Detail may not add to total due to rounding.

Discussion:

This program will be considered successful if it results in increases to employment or investment in the state. The portion of employees who would have been hired in the absence of this credit and the portion of investments that would have been made in the state in the absence of this credit is not known. Because GO-Biz examines the potential impact of each project before assigning credits, it is expected that the portion of economic activity that would not have occurred absent this credit will be greater for this credit than it would be for a credit that was available to taxpayers without any such controls.

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Child Adoption Expenses Credit

Description:

Under this program, a taxpayer is allowed a tax credit equal to 50 percent of the specified costs paid or incurred to adopt a United States citizen or legal resident minor child who was in the custody of a state or county public agency. The costs must be directly related to adoption to qualify for the credit. The eligible costs include such items as the travel expenses related to adoption and fees paid to adoption agencies and the Department of Social Services. The credit is limited to $2,500 per child. Unused credits may be carried over to following years until used.

California does not conform to federal law, however, there is a comparable federal credit.

Amount:

In tax year 2019, credits in the amount of $1.5 million were allowed.

Number of Tax Returns Affected:

In tax year 2019, credits were allowed on 1,242 PIT returns.

Distribution:

Child Adoption Expense Credit: 2019				
Adjusted Gross Income Class	Returns Claiming Credit	Returns Allowing Credit	Amount of Credit Claimed (Thousands)	Amount of Credit Allowed (Thousands)
Less than $49,999	29	27	$10.5	$9.7
$50,000 to $99,999	453	453	$318.1	$296.0
$100,000 to $199,999	598	598	$1,020.9	$876.5
More than $199,999	160	160	$382.3	$306.6
Total	1,244	1,242	$1,733.5	$1,490.6

Source: 2019 Personal Income Tax Population File
Detail may not add to total due to rounding.

Discussion:

This credit's primary purpose is to encourage the adoption of children who are in the custody of a government agency. Adoption reduces the costs to the state of caring for the adopted children, and usually provides adopted children a healthier and more stable living environment. The program can be considered successful if it leads to an increase in the number of such adoptions. The number of adoptions that would not have occurred in the absence of this credit is not known. This credit's secondary purpose is to provide relief for the hardships created by adoption procedure expenses. The credit is effective in achieving this purpose, except for those who adopt children who are not wards of the state.

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Child and Dependent Care Credit (Nonrefundable Credit)

Description:

This credit is equal to a percentage of a parallel federal credit for taxpayers with dependents who pay for child or dependent care in order to work. The credit applies to up to $3,000 in expenses for one child or $6,000 in expenses for two or more children. The California credit is calculated as a percentage of federal qualified expenses. This percentage decreases as income increases and is eliminated for taxpayers with federal AGI greater than $100,000. The maximum available credit is $525 for families with one child and $1,050 for families with two or more children.

California conforms with modifications to the federal credit. The computation of the California credit begins with the amount of the comparable federal credit.

Amount:

In tax year 2019, credits in the amount of $27 million were allowed.

Number of Tax Returns Affected:

In tax year 2019, the credits were allowed on 145,000 PIT returns.

Distribution:

Child and Dependent Care Credit: 2019				
Adjusted Gross Income Class	Returns Claiming Credit	Returns Allowing Credit	Amount of Credit Claimed (Thousands)	Amount of Credit Allowed (Thousands)
Less than $10,000	4,734	43	$1,381.7	$16.6
$10,000 to $19,999	10,704	94	$3,944.8	$12.7
$20,000 to $49,999	80,126	17,231	$23,415.7	$1,861.3
$50,000 to $99,999	147,969	127,486	$32,850.6	$25,002.8
$100,000 to $199,999	96	*	$52.7	*
More than $199,999	10	*	$52.4	*
Total	243,639	144,863	$61,697.9	$26,895.1

Source: 2019 Personal Income Tax Population File
Detail may not add to total due to rounding.
*The number of returns cannot be disclosed due to state privacy rules

Discussion:

This credit's purpose is to defray child or dependent care expenses incurred by taxpayers in order to maintain or seek employment. This credit provides relief by offsetting a portion of the cost of childcare for working taxpayers. Childcare expenses are a necessary part of working for many people. After subtracting childcare expenses, an employee who has childcare expenses has less income remaining than does another employee who earns the same salary. The Child and Dependent Care Credit is intended to make the tax burden of employees with the childcare expenses reflective of their net (after childcare expenses) rather than gross pay.

This credit successfully achieves its goal of assisting workers with their child and dependent care costs.

This credit could potentially induce two types of behavioral changes in taxpayers. The first is that some taxpayers who would not have chosen to seek employment if they had to bear the full burden of their child or dependent care expenses may now choose to seek employment. The other is that some working taxpayers who, if the credit did not exist, would have made informal arrangements for child or dependent care may now choose paid child or dependent care.

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College Access Tax Credit

Description:

The College Access Tax Credit is a credit available to individual and business entities that contribute to the College Access Tax Fund. The credit is equal to a percentage of the taxpayers' cash contribution to the fund. The credit is computed at 60 percent of the contributions in 2014, 55 percent in 2015, and 50 percent for each year from 2016 through 2022. The credit may be used to offset tax, including reducing the tax below tentative minimum tax. Unused credits may be carried over for six years. A portion of contributions to the College Access Tax Fund are used to reimburse the General Fund for the cost of the tax credit. The remainder of the funds are used to cover administrative expenses and to fund Cal Grants for college students.

The California Educational Facilities Authority is responsible for allocating and certifying the credit, on a first come first serve basis. They are authorized to allocate up to $500 million in College Access Tax Credits for each calendar year from 2014 through 2016, and $500 million in total for tax years 2017 through 2022, but have only allocated approximately $27 million total for 2014 - 2021. Any unallocated and uncertified tax credits would rollover to the next calendar year. This credit is scheduled to sunset for taxable years beginning on or after January 1, 2023.

There is no comparable federal credit. For amounts donated prior to August 27, 2018, taxpayers could claim the contributions as a charitable deduction on their federal return. IRS regulations, adopted in 2019, prevent taxpayers from claiming federal deductions for payments after August 27, 2018 that generate state tax credits such as these.

Amount:

In tax year 2019, credits in the amount of $2.5 million were allowed on PIT returns. The amount of credits allowed on corporation returns cannot be disclosed due to state privacy rules.

Number of Tax Returns Affected:

In tax year 2019, credits were allowed on 429 PIT returns. The number of corporation returns allowed this credit cannot be disclosed due to state privacy rules.

College Access Tax Credit: 2019

Adjusted Gross Income Class	Returns Claiming Credit	Returns Allowing Credit	Amount of Credit Claimed (Thousands)	Amount of Credit Allowed (Thousands)
Less than $19,999	32	31	$1.8	$1.8
$20,000 to $49,999	126	126	$42.3	$42.3
$50,000 to $99,999	89	89	$72.3	$72.3
$100,000 to $199,999	78	78	$163.2	$163.2
More than $199,999	105	105	$2,249.2	$2,249.2
Total	430	429	$2,528.9	$2,528.8

Source: 2019 Personal Income Tax Population File
Detail may not add to total due to rounding.

Discussion:

The purpose of this program is to provide additional funding for college students.

This program is structured to redirect funds from Californians' federal taxes to support for California college students at relatively low cost to California taxpayers. After claiming both the California credit and the federal charitable contribution deduction the net cost to taxpayers for donating to this fund is a small fraction of their donation. The transfer provisions in the program reimburse the General Fund for the cost of the credit. The savings from increased federal charitable donations remains in the fund and is used for Cal Grants.

If the program results in the redirection of money that was not previously being donated to charitable causes to the Cal Grant program it will be considered successful. The program may also encourage taxpayers to redirect money from other charitable donations to this program. If so, the program may be considered successful by those who believe that Cal Grants are more valuable than other charitable institutions, but will not be considered successful by those who believe that all charitable contributions should be treated equally.

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Dependent Exemption Credit in Excess of Personal Exemption Credit

Description:

This program allows taxpayers a nonrefundable credit for each of their dependents. Using the definition of tax expenditure discussed in Section 1, only the part of the dependent exemption credit that is greater than the personal exemption credit is considered the tax expenditure. The credit phases out for taxpayers whose federal AGI reaches certain thresholds. The phase-out provisions regarding the dependent exemption credit for high-income taxpayers and the requirements for nonresident taxpayers are the same as those for the personal exemption credit.

There is no comparable federal credit.

	2019	2020	2021
Exemption Credit Amount:			
Dependent Exemption Credit	$378	$383	$400
Personal Exemption Credit	$122	$124	$129
Federal AGI Limit:			
Single, Married/RDP Filing Separately	$200,534	$203,341	$212,288
Head of Household	$300,805	$305,016	$318,437
Married/RDP Filing Jointly, Qualified Widow(er)	$401,072	$406,687	$424,581

Amount:

In tax year 2019, taxpayers claimed $4.2 billion in dependent credits in addition to the personal exemption credit amount lowering their taxes by $1.5 billion.

Number of Tax Returns Affected:

In tax year 2019, the additional dependent credit was reported on 6.1 million PIT returns.

Discussion:

The program's purpose is to reduce the tax liability of taxpayers with dependents. The rationale for this is that the financial responsibilities incurred by taxpayers with dependents reduce the taxpayers' ability to pay taxes. Prior to 1998, the dependent exemption credit was equal to the personal exemption credit. The credit was increased to more accurately reflect the financial impact dependents have on a taxpayer's ability to pay taxes**.** It is not known whether the value of the dependent exemption credit that exceeds the personal exemption credit properly compensates taxpayers for the increased financial responsibilities of dependents**.** The federal government offers a dependent deduction rather than a credit. Because of California's highly progressive tax rate structure, a credit provides more tax benefit than a deduction to lower-income taxpayers.

The dependent exemption credit is successful in reducing the tax liability of taxpayers with dependents.

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Dependent Parent Credit

Description:

This credit is available to a taxpayer whose status is married filing separate, who lives apart from his or her spouse for the last half of the tax year, and covers more than half of the cost of maintaining a household (not necessarily the taxpayer's household) which was the principal home of a dependent mother or father for the year. The credit equals 30 percent of the taxpayer's net tax, was limited to $484 in 2019, and is adjusted annually for inflation.

There is no comparable federal credit.

Amount:

Credits allowed were about $663,000 in tax year 2019.

Number of Tax Returns Affected:

In tax year 2019, credits were allowed on 2,170 PIT returns.

Distribution:

Dependent Parent Credit: 2019				
Adjusted Gross Income Class	Returns Claiming Credit	Returns Allowing Credit	Amount of Credit Claimed (Thousands)	Amount of Credit Allowed (Thousands)
Less than $10,000	12	11	$1.3	$1.1
$10,000 to $19,999	81	80	$1.8	$1.2
$20,000 to $49,999	886	878	$179.1	$138.3
$50,000 to $99,999	835	816	$366.9	$341.2
$100,000 to $199,999	324	307	$171.1	$145.0
More than $199,999	85	78	$44.5	$36.2
Total	2,223	2,170	$764.7	$663.0

Source: 2019 Personal Income Tax Population File
Detail may not add to total due to rounding

Discussion:

The purpose of this credit is to provide relief for certain taxpayers who bear the burden of maintaining a residence for his or her parent(s), but do not qualify for other forms of tax relief such as head of household filing status. The credit is successful at directing resources to its target group. A policy alternative would be direct housing subsidies for the qualifying dependent.

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Disabled Access Expenditure Credit

Description:

The Disabled Access Expenditure Credit allows small businesses a tax credit for providing access to disabled persons. The credit is limited to 50 percent of the first $250 of eligible expenses. To qualify for the credit, the business must either have less than $1 million of gross receipts in the previous year or employ no more than 30 full-time employees.

California conforms to the federal definition of expenses that qualify for this credit. California’s credit amount and eligible expense limitation differ from federal law.

Amount:

In tax year 2019, credits in the amount of $33,500 on PIT returns and $8,078 on corporate tax returns were allowed.

Number of Tax Returns Affected:

In tax year 2019, credits were allowed on 444 PIT returns and 149 corporate tax returns.

Distribution:

Disabled Access Expenditure Credit (PIT): 2019				
Adjusted Gross Income Class	Returns Claiming Credit	Returns Allowing Credit	Amount of Credit Claimed (Thousands)	Amount of Credit Allowed (Thousands)
Less than $49,999	30	30	$1.3	$1.3
$50,000 to $99,999	41	41	$3.5	$3.5
$100,000 to $199,999	132	132	$11.6	$11.6
$200,000 to $499,999	137	137	$10.7	$10.4
$500,000 to $999,999	54	54	$3.7	$3.7
More than $999,999	50	50	$3.2	$3.2
Total	444	444	$33.9	$33.6

Source: 2019 Personal Income Tax Population File
Detail may not add to total due to rounding.

Disabled Access Expenditure Credit Allowed by Industry (Corporation): 2019				
	Returns with Credit		Percent of Total	
Industry	Returns Allowing Credit	Amount of Credit Allowed (Thousands)	Returns	Credit Allowed
Food Services	14	$0.7	9.4%	8.3%
Health Care	78	$4.3	52.4%	53.2%
Real Estate	18	$1.0	12.1%	11.8%
Other	39	$2.2	26.2%	26.7%
Total	149	$8.1	100.0%	100.0%

Source: 2019 Business Entity Tax System Extract
Detail may not add to total due to rounding.

Discussion:

The purpose of this program is to provide tax relief to taxpayers for their qualified expenditures incurred in complying with the federal Americans with Disabilities Act. This program complements a federal tax credit for 50 percent of qualified expenditures exceeding $250 and up to $10,250. The program is successful at directing resources to the targeted uses; but, since the credit is nonrefundable, it is successful only to the extent that taxpayers have tax liability to offset.

An alternative to this credit would be to have the state partially or fully subsidize the cost of disabled access retrofits.

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Donated Fresh Fruit and Vegetables Credit

Description:

This program provides taxpayers a credit for 15 percent of the cost associated with the donation of fresh fruits or fresh vegetables to a California food bank. Taxpayers may carryover any excess credit for up to seven years.

There is no comparable federal credit.

Amount:

In tax year 2019, credits in the amount of $1.4 million on PIT returns and $100,000 on corporation tax returns were allowed.

Number of Tax Returns Affected:

In tax year 2019, credits were allowed on 383 PIT returns and 14 on corporate tax returns.

Distribution:

Donated Fresh Fruit and Vegetables Credit: 2019

Adjusted Gross Income Class	Returns Claiming Credit	Returns Allowing Credit	Amount of Credit Claimed (Thousands)	Amount of Credit Allowed (Thousands)
Less than $49,999	118	117	$185.8	$185.8
$50,000 to $99,999	134	134	$56.3	$56.3
$100,000 to $199,999	47	47	$29.6	$29.6
More than $199,999	85	85	$1,094.7	$1,094.7
Total	384	383	$1,366.4	$1,366.4

Source: 2019 Personal Income Tax Population File
Detail may not add to total due to rounding.

Discussion:

The purpose of this program is to encourage taxpayers to donate fresh fruits and vegetables to food banks. The underlying rationale is that food banks provide a socially beneficial service by distributing food to needy individuals, and that this service is worthy of indirect state support. By partially offsetting the cost of the donations, the program encourages more taxpayers to donate. Thus, more fresh fruits and vegetables may reach food banks due to the incentive.

In the absence of this credit, the value of the donated fresh fruits and vegetables would still be tax deductible. It is unclear why the donation of fresh fruits and vegetables should be treated more favorably than other charitable contributions.

To be considered effective, this credit must increase the amount of fresh fruits and vegetables donated to charitable organizations. It is not known whether this credit increases fresh fruits and vegetables donations to charitable organizations.

Policy alternatives include increases in targeted aid (i.e., food stamps to disadvantaged individuals and government grants to charitable institutions providing food assistance).

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Earned Income Tax Credit

Description:

The Earned Income Tax Credit (EITC) allows a refundable tax credit for low income working families. The credit amount is determined by the number of qualified children and the amount of qualified income and is structured with credit phase-in and phase-out income ranges. The Legislature also must authorize spending funds for this credit in each state budget. In 2015, only wage income was allowed for determining the amount of qualified income. Beginning in 2017, the credit's phase-out income range was extended and taxpayers with self-employment income can claim the credit. In 2018, the credit's phase-out range was extended again and childless taxpayers under 25 and over the age of 64 can claim the credit. For tax years beginning on or after 2019, the credit's phase-out income range was extended to $30,000 for all taxpayers. For 2020, the credit was expanded to include taxpayers with individual taxpayer identification numbers (ITIN).

California conforms with modifications to the federal Earned Income Tax Credit. California's credit percentages and phase-in and phase-out income ranges differ from federal law.

Amount:

In tax year 2019, credits in the amount of $750 million were allowed.

Number of Tax Returns Affected:

In tax year 2019, credits were allowed on 3.9 million PIT returns.

Discussion:

The Earned Income Tax Credit is an anti-poverty program for both adults and children in lower income working families. The primary purpose of the program is to lift people out of poverty and to encourage labor market participation by providing additional benefits from employment. The credit is widely considered a successful program for encouraging work amongst low income families.

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Enhanced Oil Recovery Costs Credit

Description:

Certain independent oil producers are allowed a nonrefundable credit (with carry forward) equal to 5 percent of the qualified enhanced oil recovery costs for projects located in California. Taxpayers who are retailers of oil or natural gas or who are refiners of crude oil whose daily output exceeds 50,000 barrels are not eligible for the credit. The credit is unavailable if the reference price of domestic crude oil increases above a specified threshold for the preceding year. The reference price for taxable year 2019 was $61.41, which exceeded the inflation-adjusted threshold price of $48.5352 for 2018. Thus, the credit was completely phased out in 2019. However, the credit was available in taxable years 2016 and, 2017 because the reference price for oil fell below the threshold price. For taxable year 2018, the credit was partially phased out.

Except for the geographic limitation, the California credit is generally available for the same activities as the parallel federal 15 percent credit.

Amount:

In tax year 2019, the amount and number of PIT and corporate tax returns cannot be disclosed due to state privacy rules.

Discussion:

The primary purpose of this credit is to increase the use of qualified oil and gas recovery technologies. In general, these technologies are more expensive than other oil and gas technologies, but increase the amount of oil and gas produced by a particular oil and gas field. One benefit of this increased production is a decreased reliance on oil and gas imports. A secondary purpose of this credit is to provide independent producers a competitive advantage relative to integrated oil and gas companies.

The increased use of these technologies is only desirable if free market incentives plus the 15 percent federal credit are insufficient to induce use of the optimal amount of these technologies. For this to be the case, enhanced recovery must produce externalities, "benefits to society that cannot be captured by the business that generates them." The externality that may arise in this case comes from a reduction in the importation of foreign oil. Foreign oil dependency (particularly with foreign sources that are politically unstable or unsavory) increases the risk of dramatic fluctuations in the supply and the price of oil. These fluctuations may be very damaging to the economy. They may also induce dangerous foreign policy entanglements.

The purpose of this credit will be achieved if the credit induces increased use of qualified recovery technologies. Credits claimed for recovery operations that would have been undertaken even in the absence of this credit are windfalls. The amount of qualified activity that would not have been undertaken in the absence of this credit is not known. Since the externalities justifying this credit are national rather than specific to California, it is not clear why California should be offering this credit.

The second purpose will be achieved if it increases the market share of independent oil and gas recovery firms. While it is clear that this credit offers the independent firms a competitive advantage in this area, it is not known if market shares would be different in the absence of this credit. Nor is it obvious why California would want to increase independent producers' share of the oil recovery industry.

States often provide add-on credits to federal credits in order to encourage businesses to locate activity in their state rather than another state. However, this credit seems unlikely to reap any benefits of this sort, because existing oil and gas fields cannot be moved to another state.

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Joint Custody Head of Household Credit

Description:

This credit is for divorced or separated individuals who incur significant costs to maintain a home for a dependent for part of the year. The other custodial individual who provides the principal residence for the same dependent qualifies for the head of household filing status and would not qualify for this credit.

There is no comparable federal credit.

The amount of the credit is the lesser of 30 percent of a taxpayer's net tax or a maximum amount determined annually: $484 in 2019, $491 in 2020, and $513 in 2021. To qualify for the credit, a taxpayer must:

- Provide at least 50 percent of the cost of maintaining the dependent's principal residence for at least 146 days, but no more than 219 days of the tax year; and
- Either:
    1. Be divorced or legally separated from the child's other parent and use the single filing status, or
    2. Live apart from their spouse and file under married filing separate status.

A taxpayer who maintains the principal residence of the dependent for more than 219 days a year qualifies for the head of household status that is more advantageous.

Amount:

In tax year 2019, credits in the amount of $2.1 million were allowed.

Number of Tax Returns Affected:

In tax year 2019, credits were allowed on 6,292 PIT returns.

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Distribution:

Joint Custody Head of Household Credit: 2019				
Adjusted Gross Income Class	Returns Claiming Credit	Returns Allowing Credit	Amount of Credit Claimed (Thousands)	Amount of Credit Allowed (Thousands)
Less than $10,000	18	15	$3.2	$2.2
$10,000 to $19,999	213	211	$5.0	$4.0
$20,000 to $49,999	2,327	2,319	$431.1	$408.9
$50,000 to $99,999	2,519	2,509	$1,150.7	$1,124.6
$100,000 to $199,999	1,003	997	$481.6	$477.2
More than $199,999	243	241	$126.5	$115.8
Total	6,323	6,292	$2,198.1	$2,132.7

Source: 2019 Personal Income Tax Population File
Detail may not add to total due to rounding.

Discussion:

The intent of the tax credit is to provide financial relief to taxpayers who are divorced or separated, have custody of their children for a significant portion of the year, and do not qualify to file under a head of household filing status. The head of household filing status is generally allowed to parents (single, divorced, or separated) whose children live with them for more than half the year. To compensate taxpayers for expenses borne on behalf of their dependents, the head of household status provides for lower tax rates than does the single filing status. Where parents have a joint custody agreement, providing for equal shared custody, it is common that neither will qualify for head of household filing status. Thus, they must compute their tax at the higher single status tax rate. This credit recognizes that taxpayers whose children live with them for part of a year have greater expenditures than (otherwise similarly situated) taxpayers with no children, but lower expenditures than taxpayers whose children live with them for more than half of the year. This credit allows these taxpayers some relief, but not as much as if the children were living with them for the period of time required to qualify for the more favorable head of household tax rates. This credit is successful in reducing the tax liability of taxpayers with joint custody arrangements.

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Low-Income Housing Expenses Credit

Description:

This is a tax credit provided for a portion of the costs of investing in qualified low-income rental housing. The aggregate amount of the credit is capped, and the California Tax Credit Allocation Committee allocates specific credits to applicants. Credits are allocated to developers who, in turn, sell them to investors in exchange for project funding. All projects receiving the California credit must also receive the parallel federal credit.

California conforms with modifications to the federal Low Income Housing Credit and is intended to supplement the federal credit.

Amount:

In tax year 2019, credits in the amount of $223,000 for PIT and $27 million for corporations were allowed.

Number of Tax Returns Affected:

In tax year 2019, the credit was allowed on 190 PIT returns and 29 corporation tax returns.

Distribution:

Low-Income Housing Expenses Credit (PIT): 2019				
Adjusted Gross income Class	Returns Claiming Credit	Returns Allowing Credit	Amount of Credit Claimed (Thousands)	Amount of Credit Allowed (Thousands)
Less than $49,999	27	27	$3.8	$3.8
$50,000 to $99,999	30	30	$17.7	$17.6
$100,000 to $199,999	45	45	$48.3	$48.3
$200,000 to $499,999	38	38	$92.6	$92.6
$500,000 to $999,999	22	22	$6.7	$6.7
More than $999,999	28	28	$53.9	$53.9
Total	190	190	$223.0	$222.9

Source: 2019 Personal Income Tax Population File
Detail may not add to total due to rounding.

Low-Income Housing Expenses Credit Allowed by Industry (Corporation): 2019				
	Returns with Credit		Percent of Total	
Industry	Returns Allowing Credit	Amount of Credit Allowed (Millions)	Returns	Credit Allowed
Finance and Insurance	13	$9.6	44.8%	35.9%
Other	16	$17.2	55.2%	64.1%
Total	29	$26.8	100.0%	100.0%

Source: 2019 Business Entity Tax System Extract
Detail may not add to total due to rounding.

Discussion:

This credit's purpose is to increase the supply of affordable rental housing units available to low-income California households. It encourages production of affordable rental housing by subsidizing investments in qualified projects.

This program supplements a parallel federal tax credit. Under the federal program, the amount of money available for each state is capped at the same per capita funding level ($2.76 per state resident in 2019, adjusted for inflation beginning in 2003). California elected to supplement this credit, because the costs of housing in California are higher than the national average.

The program can be considered successful if it leads to increased production of affordable rental housing. For qualified units that would have been constructed even in the absence of this credit, the credit is a windfall. The proportion of qualified units that would not have been constructed in the absence of this credit is not known.

Policy alternatives to this credit could include vouchers that low-income households could use toward making rental payments for housing priced at market levels or alternative tax benefits to developers, such as expensing of costs for building qualified low-income housing units.

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Motion Picture Credit

Description:

The Motion Picture Credit allows a tax credit for motion picture production expenses in California. The credit is equal to 20 percent of qualified expenditures for feature films, new television series, movies-of-the-week, mini-series, and television pilots. The credit allocation for feature films is limited to the first $100 million in qualified expenditures. The credit is 25 percent for independent films and for TV series that relocate to California. The credit allocation for independent films is limited to the first $10 million in qualified expenditures.

There is no comparable federal credit.

The California Film Commission is responsible for allocating and certifying the credit. The Commission can award up to $330 million per fiscal year. Unallocated credits are available for allocation during future years. The Commission may award an additional $15 million to relocating television series and $75 million to recurring television series in fiscal years 2021-22 and 2022-23.

Credits may be assigned to affiliates or used to offset sales and use tax owed or paid by the taxpayer. Additionally, credits awarded for independent films may be sold to a third party.

Amount:

In tax year 2019, credits in the amount of $6 million for PIT and $55 million for corporations were allowed.

Number of Tax Returns Affected:

In tax year 2019, the credit was allowed on 14 PIT returns and 10 corporation tax returns.

Discussion:

The Motion Picture Credit is designed to encourage motion picture companies to remain in California or to relocate to California. To be considered effective, the program must induce filmmakers to undertake activities in California rather than elsewhere. The portion of qualifying projects that would have been filmed in California in the absence of this credit is not known.

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Natural Heritage Preservation Credit

Description:

The Natural Heritage Preservation Tax Credit provides a nonrefundable credit to taxpayers who donate property for conservation purposes. The amount of the tax credit equals 55 percent of the fair market value of the donated real property. Unused credit may be carried over for up to 15 years. The California Wildlife Conservation Board must approve property donations. Prior to approving any credits, the board must find that bond act monies or local funds would be provided to eliminate any General Fund cost. In 2021, Assembly Bill 1219 reinstated the credit for the period January 1, 2021 through June 30, 2026.

There is no comparable federal credit.

Since its initial implementation in 2001, the Wildlife Conservation Board has approved $48.2 million in tax credits to date.

Amount:

In tax year 2019, there was no PIT credit allowed and the amount of corporation credit allowed cannot be disclosed due to state privacy rules.

Number of Tax Returns Affected:

In tax year 2019, there were no PIT returns reported and the number of corporate returns cannot be disclosed due to state privacy rules.

Discussion:

This program's purpose is to encourage donations of qualified property for permanent preservation.

To be considered successful, this credit must induce preservation of land that would have been developed absent this credit. Any credits granted for land that would never have been developed anyway are windfalls to the recipient. It is not known if any credited lands would have been developed in the absence of this credit.

Policy alternatives could include: purchasing lands for conservation directly, increasing zoning restrictions on development, or increasing the costs of development through increased regulatory burdens on development techniques or environmental impacts.

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New Advanced Strategic Aircraft Credit

Description:

Employers may take a credit equal to 17 ½ percent of qualified wages for each qualified employee they hire. A qualified taxpayer must be a major first-tier subcontractor awarded a subcontract to manufacture property for ultimate use in or as a component of a new advanced strategic aircraft for the United States Air Force. The credit is available for tax years beginning January 1, 2016 through December 31, 2030.

Qualified aerospace companies are allowed a credit equal to 17.5 percent of wages paid to qualified employees during a taxable year with annual caps over 15 years ranging from $25 to $31 million.

The total aggregate amount of the credit that may be allowed to all qualified taxpayers would be:

- In years one through five of the credit, the total aggregate amount allowed shall not exceed $25,000,000 per calendar year.
- In years six through ten of the credit, the total aggregate amount allowed shall not exceed $28,000,000 per calendar year.
- In years 11 through 15 of the credit, the total aggregate amount allowed shall not exceed $31,000,000 per calendar year.

There is no comparable federal credit. However, there is a federal wage credit for new hires based on different qualifications and amounts.

Amount:

In tax year 2019, this credit is a tax expenditure, but due to state privacy rules the amount and number of taxpayers impacted cannot be disclosed.

Discussion:

This credit's purpose is to encourage investment in California for the design, testing, or production of a new advanced strategic aircraft for the U.S. Air Force.

To be considered successful, this program must increase the number of jobs in the aerospace industry in California. The number of aerospace jobs that would have remained, moved, or been created in California in the absence of this credit is not known.

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New Employment Credit

Description:

Employers may take a credit equal to 35 percent of qualified wages for each qualified employee they hire. A qualified taxpayer must have a net increase in its total number of full-time employees working in California. The credit is available for tax years beginning January 1, 2014 through December 31, 2025.

There is no comparable federal credit. However, there is a federal wage credit for new hires based on different qualifications and amounts.

Amount:

In tax year 2019, credits in the amount of $2.7 million on PIT returns and $780,000 on corporation tax returns were allowed.

Number of Tax Returns Affected:

In tax year 2019, credits were allowed on 277 PIT returns and 111 corporate tax returns.

Distribution:

New Employment Credit: 2019				
Adjusted Gross Income Class	Returns Claiming Credit	Returns Allowing Credit	Amount of Credit Claimed (Thousands)	Amount of Credit Allowed (Thousands)
Less than $49,999	40	39	$60.9	$60.6
$50,000 to $99,999	23	23	$34.4	$34.4
$100,000 to $199,999	39	39	$132.3	$132.3
More than $199,999	176	176	$2,507.2	$2,507.2
Total	278	277	$2,734.8	$2,734.6

Source: 2019 Personal Income Tax Population File
Detail may not add to total due to rounding.

Discussion:

The purposes of the hiring credit are to encourage business activity in designated, depressed areas of the state, and also to encourage employment for designated classes of individuals.

This program will be considered successful if it creates new jobs. If the program moves jobs from other parts of California into the economically depressed area, it may be considered successful if either: 1) policymakers view jobs in depressed areas as more valuable than jobs in other parts of the state; or 2) the spillover benefits to the economy from job creation are greater in depressed areas than in other parts of the state. For any jobs that would have been created irrespective of this credit, this provision represents a windfall gain to the taxpayer. We have no way of knowing this credit’s effect on the relative proportions of jobs that would have been created in the depressed area anyway, the number that would have been created elsewhere in the state, or the number that would not have been created at all.

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Prison Inmate Labor Costs Credit

Description:

This program allows employers a tax credit equal to 10 percent of the wages they pay to state prison inmates employed in a joint-venture program between the taxpayer and the California Department of Corrections and Rehabilitation. This program resulted from the approval of Proposition 139 (1990), Prison Inmate Labor.

There is no comparable federal credit.

Amount:

In tax year 2019, the amount and number of PIT and corporate tax returns cannot be disclosed due to state privacy rules.

Discussion:

The purpose of this credit is to increase the number of inmates hired under joint-venture programs. It is hoped that this employment will enhance prospects for the inmates' employment once they are released from prison, and reduce recidivism. In addition to the potential benefit to the rehabilitation of the inmate, part of the wages earned by inmates is used in a socially beneficial way – either to pay taxes, pay for prison room and board, pay restitution to crime victims, or provide support for the inmate's family.

In order to be effective, this program must increase the number of inmates employed in joint-venture programs. The programs must enable inmates to acquire better employment after release from prison or reduce recidivism rates. It is not known how many inmates in this program would not have been hired in the absence of this credit or how employment in this program affects employment after release. Studies have found that employment of inmates does improve post-release employment prospects and reduces recidivism.

Other California programs that also contribute to the goal of meaningful employment for released prisoners include support services provided to inmates after release and a variety of employment training programs and hiring incentives that are not targeted specifically at inmates.

It is not known whether pre-release or post-release programs are more effective in achieving the goal of increasing the employability of inmates.

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Qualified Senior Head of Household Credit

Description:

This program allows qualified taxpayers 65 years or older to claim a credit equal to 2 percent of taxable income. Qualified taxpayers are those who qualified for head of household status in at least one of the two preceding tax years, but no longer qualify because the qualifying individual that they supported has died. This credit is limited to taxpayers with adjusted gross income less than the specified amounts which are adjusted annually for inflation.

There is no comparable federal credit.

	2019	2020	2021
Maximum Credit Limitation	$1,478	$1,499	$1,565
California AGI Limitation	$78,441	$79,539	$83,039

Amount:

In tax year 2019, credits in the amount of $2.7 million were allowed.

Number of Tax Returns Affected:

In tax year 2019, credits were allowed on 5,150 PIT returns.

Distribution:

Qualified Senior Head of Household Credit: 2019				
Adjusted Gross Income Class	Returns Claiming Credit	Returns Allowing Credit	Amount of Credit Claimed (Thousands)	Amount of Credit Allowed (Thousands)
Less than $10,000	19	14	$5.8	$3.2
$10,000 to $19,999	40	19	$6.0	$1.7
$20,000 to $49,999	1,703	1,663	$439.7	$408.3
More than $49,999	3,500	3,454	$2,347.0	$2,237.1
Total	5,262	5,150	$2,798.5	$2,650.3

Source: 2019 Personal Income Tax Population File
Detail may not add to total due to rounding.

Discussion:

This credit is designed to provide tax relief to low-income seniors who qualified for head of household filing status because they provided a household for a qualifying individual (generally a dependent relative, but not a spouse) who died during one of the two preceding years. Presumably, most of the taxpayer's expenses from the care of the qualifying individual ended soon after the qualifying individual's death, so it is not clear why these taxpayers require relief for two additional years. There are few qualified taxpayers with incomes between the zero tax threshold and the income limit for this credit.

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Renter's Credit (Nonrefundable Credit)

Description:

This program provides a credit to low-income taxpayers who rent their primary residence. Since 1999, the credit has been nonrefundable.

There is no comparable federal credit.

The amount of the credit is $60 for single and married filing separately filers with income not exceeding the California AGI limitation. The credit amount is $120 for married filing jointly, head of household and qualified widower.

California AGI Limitation Amounts	2019	2020	2021
Single, Married/RDP Filing Separately	$42,932	$43,533	$45,448
Head of Household	$85,864	$87,066	$90,896
Married/RDP Filing Jointly, Qualified Widow(er)	$85,864	$87,066	$90,896

Amount:

In tax year 2019, taxpayers claimed $247 million in credits, reducing their taxes by $146 million.

Number of Tax Returns Affected:

In tax year 2019, credits were allowed on 2 million PIT returns.

Distribution:

Renter's Credit: 2019				
Adjusted Gross Income Class	Returns Claiming Credit (Thousands)	Returns Allowing Credit (Thousands)	Amount of Credit Claimed (Millions)	Amount of Credit Allowed* (Millions)
Less than $10,000	285.0	31.5	$20.2	$1.0
$10,000 to $19,999	497.2	245.2	$35.4	$11.0
$20,000 to $49,999	1,666.3	1,287.4	$126.5	$79.7
$50,000 to $69,999	339.4	277.4	$39.2	$30.4
More than $69,999	217.7	206.6	$25.8	$24.2
Total	3,005.6	2,048.1	$247.0	$146.3

Source: 2019 Personal Income Tax Population File
File Detail may not add to total due to rounding.
*Amount of credit allowed is the amount by which tax was reduced by the credit. Amount claimed may be larger if the taxpayer does not owe enough tax before the credit to use the full amount that they otherwise could, or if the taxpayer is subject to other limits such as credit phase-outs based on income.

Discussion:

The intent of this credit is to counteract a perceived inequity between renters and homeowners. The credit was originally enacted in 1972 as part of a comprehensive property tax reform program. That program allowed for an increase in the Homeowner's Property Tax Exemption Credit that reduces the property tax on owner-occupied property. In contrast, rental property is not eligible for the homeowner's exemption. The Renter's Credit was intended to equalize property taxes between renters and homeowners by providing a benefit directly to the renter. This credit was increased significantly in 1979 shortly after the approval of Proposition 13, *Property Tax Limitation*. It was thought that owners of real property were receiving a benefit from Proposition 13, but that renters received no benefit.

The extent to which this credit realizes its objective depends on both the nature of the homeowner's benefit it is intended to parallel and on conditions in the rental market. The credit is more likely to be justifiable if it is intended to be the renter's counterpart to the homeowner's exemption than if it is intended as an expansion of Proposition 13. This is because rental property does benefit from Proposition 13. If the rental market is favorable to renters, landlords may be forced by the market to pass their Proposition 13 savings to renters by lowering rents. In this case, the Renter's Credit is unnecessary. Since rental property is not eligible for the homeowner's exemption, there is no savings to pass along. Therefore, the credit may be justified as matching the homeowner's exemption.

This credit may also fail to achieve its objective if conditions in the rental market are favorable to landlords. Under these market conditions, landlords may be able to increase rents by an amount equal to the Renter's Credit, leaving no benefit to the renters.

Two other aspects of this credit may be worth noting. One is that the benefits from the homeowner's exemption and Proposition 13 are the same, regardless of the taxpayer's filing status. It is not clear why, if the Renter's Credit is intended to mimic these provisions, the credit is twice as large for joint filers as for single filers. The second is that this credit, by helping renters, offers an inducement to rent. Although relatively small, this inducement works against the numerous government policies encouraging people to purchase homes rather than rent.

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Research and Development (R&D) Expenses Credit

Description:

This provision allows taxpayers to claim a portion of their incremental R&D expenses as a credit. Incremental expenses are calculated as increases in the ratio of a taxpayer's current-year R&D expenses to gross sales relative to a four-year base period. The credit is equal to 15 percent of qualified incremental R&D expenses and 22 percent of qualified incremental "basic" R&D expenses. Basic R&D is "research conducted at qualified universities or scientific research organizations." Since 1998, California has allowed taxpayers to elect an alternative formula for calculating their R&D credit. This alternative amount is calculated as a percentage of the federal Alternative Incremental Credit amount. Once made, the alternative formula election is binding for all future years.

California conforms with modifications to the federal Research Tax Credit.

Amount:

In tax year 2019, credits in the amount of $229 million on PIT returns and $2 billion corporation tax returns were allowed.

Number of Tax Returns Affected:

In tax year 2019, credits were allowed on 19,700 PIT returns and 5,300 corporate tax returns.

Distributional Analysis:

The tables below present information on the distribution of R&D credits by size of gross receipts and by industry. Although firms with gross receipts greater than $1 billion represent 6 percent of returns that claim the R&D credit, they report 88 percent of total credits allowed. Approximately 28 percent of returns claiming R&D credits come from the manufacturing sector. These returns account for 23 percent of the R&D credits allowed. Within this sector, electronic and electrical equipment claimed the largest amount of R&D credit, accounting for 7 percent of returns, and 10 percent of R&D credits allowed.

Research and Development Credit Allowed by Size of Gross Receipts (Corporate): 2019

	Returns with Credit		Percent of Total	
Size of Gross Receipts	Returns Allowing Credit	Amount of Credit Allowed (Millions)	Returns	Credit Allowed
Not Known	249	$61.9	4.7%	3.1%
Less than $500 million	4,592	$135.2	86.6%	6.7%
$500 million to $1 billion	123	$44.7	2.3%	2.2%
More than $1 billion	337	$1,773.1	6.4%	88.0%
Total	5,301	$2,014.9	100.0%	100.0%

Source: 2019 Business Entity Tax System and Corporate Return Samples
Detail may not add to total due to rounding.

Research and Development Credits Allowed by Industrial Subsector (Corporate): 2019				
	Returns with Credit		Percent of Total	
Industrial Subsector	Returns Allowing Credit	Amount of Credit Allowed (Millions)	Returns	Credit Allowed
Food and Kindred Products	86	$9.0	1.6%	0.5%
Chemicals and Allied Products	63	$6.2	1.2%	0.3%
Pharmaceuticals	39	$41.9	0.7%	2.1%
Electrical and Electronic Equipment	385	$206.1	7.3%	10.2%
Other Manufacturing	885	$201.5	16.7%	10.0%
Information	276	$468.9	5.2%	23.3%
Other	3,567	$1,081.4	67.3%	53.7%
Total	5,301	$2,014.9	100.0%	100.0%

Source: 2019 Business Entity Tax System and Corporate Return Samples
Detail may not add to total due to rounding.

Discussion:

The California R&D credit normally is taken in conjunction with the federal Research Tax Credit. For taxpayers that elect to use the Regular method, the calculation to determine the amount of qualified California research expenses conforms to the federal calculation with one exception: the qualified research activities must be conducted in California. California law allows taxpayers to elect the Alternative Incremental method. This method was previously, but is no longer, an option under federal law. Federal law allows taxpayers to instead elect the Alternative Simplified method, but California does not.

At the federal level, there are two reasons to encourage R&D. First, without extra incentives, industry will typically do less R&D work than would be optimal for society. This is because R&D activity often produces "positive externalities" (i.e., benefits to people other than the person doing the R&D). The federal R&D credit reduces the after-tax cost of R&D investments, which should lead to an increase in R&D activity. Since state R&D credits also reduce the after-tax cost of R&D, they too will induce an increase in the overall level of R&D spending. The federal R&D credit's second purpose is to encourage taxpayers to conduct R&D in the United States, rather than in another country. Since the structure of the California R&D credit generally conforms to that of the federal credit, the California credit will produce both of these same effects. It will contribute to an overall increase in R&D activity, and it will encourage R&D activity to be undertaken in California rather than elsewhere. Because California's contribution to total R&D spending is smaller than the federal government's contribution, the first effect, global increases in R&D activity, is somewhat less important to state policy than to federal policy. The second effect, regional competition, is a relatively more important motivator for state policy. This is because it may be easier for some R&D firms to move their activity to another state than it would be for them to move it to another country, and many states besides California offer R&D credit. Therefore, a California credit may be necessary for the state to remain competitive with other states in attracting and maintaining research and development business activity.

Both effects of the California R&D credit, the increase in the overall amount of R&D activity, and the increase in the proportion of this activity that takes place in California must be considered in evaluating the success of the R&D credit. The desirability of the increase in overall R&D activity is dependent on the level of the federal R&D credit (and credits offered by other states and countries). If the federal credit is too low, the added R&D incentives provided by states collectively could generate productive additional R&D activity. Alternatively, if the federal credit has already induced optimal levels of R&D, any increases in overall R&D spending induced by additional state credits will be inefficient and hurt overall economic performance. It is not known whether the federal R&D credit is currently set at the optimal level.

The R&D credit may be viewed as successfully maintaining the competitiveness of the California R&D industry only if R&D activity is undertaken in California that would not have been undertaken here in the absence of the credit. The amount of California R&D activity that would not have taken place in California in the absence of the credit is not known. Credits granted for R&D that would have occurred even in the absence of the credit may be considered a windfall.

There are two possible benefits of attracting the R&D business to California. The first is the addition of the R&D jobs. If this were the only benefit, the R&D industry should be singled out for this special benefit only if jobs in this industry are substantially more desirable than jobs in other industries in the state. The second potential benefit in bringing R&D to California is that other California businesses may be able to adopt innovations developed locally more rapidly than they can adopt innovations developed elsewhere. If this is the case, many California businesses, not just those receiving this credit, will gain an advantage over their rivals in other states. This advantage is not a result of being able to obtain technological information more quickly. Given the global communications network, information can be transported across continents relatively quickly and with minimal cost. The advantage to California may come through something economists call "economies of agglomeration". Economies of agglomeration are defined as "a reduction in production costs that result when firms in the same or related industries locate near one another."

Thus, for example, if the R&D credit encourages some pharmaceutical companies to locate their research facilities in California, that will, encourage the growth of pharmaceutical research support firms (i.e., material suppliers, pharmaceutical manufacturers, universities doing biological and chemical research, chemical engineers, etc.) to be attracted to that area. Subsequently, with the growth of the support industries, other pharmaceutical firms will be attracted to the area. There are clearly many agglomeration economies within California (high-technology in Silicon Valley and motion pictures in Hollywood are two examples). However, many factors contribute to the development and growth of agglomeration economies. Because of the complexity of agglomeration economies, the extent to which the California R&D credit has encouraged the development or growth of any agglomeration economies is not known.

The inability to fully use the credit (because there is insufficient tax to offset) undoubtedly reduces the incentive provided by the existence of the credit.

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Senior Exemption Credit

Description:

This program provides taxpayers over age 65 with an additional personal exemption credit.

There is no comparable federal credit, however, federal law provides an additional deduction for these taxpayers.

The credit is adjusted annually for inflation. For example, in 2019, the credit was $122 for each taxpayer over the age 65. For joint filers, if only one were over the age 65, the credit was $122. If both taxpayers were over age 65, the credit was $244. The exemption credit was $114 in 2017 and $118 in 2018.

Amount:

In tax year 2019, taxpayers claimed $515 million in senior exemption credits, lowering their taxes by about $328 million.

Number of Tax Returns Affected:

In tax year 2019, this credit was reported on 3.1 million PIT returns.

Distribution:

Senior Exemption Credit: 2019			
Adjusted Gross Income Class	Returns Reporting Credit (Thousands)	Amount of Credit Claimed (Millions)	Tax Impact of Credit (Millions)
Less than $10,000	373.2	$56.6	$36.1
$10,000 to $19,999	294.3	$43.8	$27.9
$20,000 to $49,999	636.8	$98.7	$62.9
$50,000 to $99,999	792.0	$127.5	$81.3
$100,000 to $199,999	662.0	$119.5	$76.2
More than $199,999	370.0	$68.9	$43.9
Total	3,128.4	$514.9	$328.3

Source: 2019 Personal Income Tax Population File and Microsimulation Model
Detail may not add to total due to rounding.

Discussion:

This credit provides hardship relief on the grounds that taxpayers over age 65 are believed to have higher medical and personal costs relative to income than other taxpayers. This credit is similar to a provision of federal law that allows an additional deduction from adjusted gross income for this group of taxpayers. In 2019, the amount of the federal deduction above the standard deduction was $1,650 for single filers or head of household and $2,600 for joint filers, both of whom are over age 65.

This credit is effective in reducing the tax liability of taxpayers over age 65.

This credit is available to all taxpayers over age 65, even if they have no extraordinary expenses. To the extent that this credit is intended to offset medical expenses, it may be unnecessary in light of other available benefits, including the itemized deduction for medical expenses and direct government expenditures and provisions for medical care for the elderly.[9] Furthermore, some nonelderly taxpayers can face circumstances in which they have higher medical or other personal costs. If the credit were intended to offset certain medical and other personal costs, it would be more equitable and more efficient to target the credit to all those who face these higher costs, regardless of whether or not they are elderly. However, it is possible that the costs of targeting the credit with greater specificity could outweigh any equity and efficiency benefits that would accrue.

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Transportation of Donated Agricultural Products Credit

Description:

This program provides taxpayers a credit for 50 percent of costs paid or incurred in transporting agricultural products donated to a nonprofit, charitable organization.

There is no comparable federal credit.

[9] It could be argued that the itemized deduction for medical expenses is not useful for many elderly taxpayers -- either because they do not itemize, or because taxpayers are only allowed to deduct medical expenses greater than 7.5 percent of AGI. While this is true for elderly taxpayers, it is also true for many nonelderly taxpayers. This point, thus, argues for a more specific credit for all taxpayers with medical expenses, rather than a generic credit for all elderly taxpayers.

Amount:

In tax year 2019, credits in the amount of $46,000 were allowed.

Number of Tax Returns Affected:

In tax year 2019, credits were allowed on 27 PIT returns. The number of corporation returns allowed this credit cannot be disclosed due to state privacy rules.

Discussion:

The purpose of this program is to encourage taxpayers to donate the transportation of, or incur the costs for, transporting agricultural products to charitable organizations. The underlying rationale is that charitable organizations are providing a socially beneficial service by distributing agricultural products to needy individuals, and that this service is worthy of indirect state support. By partially offsetting the costs of transporting the agricultural products, the program encourages more taxpayers to donate or incur the costs of transporting these products. Thus, more agricultural products may reach charitable organizations than otherwise would without the incentive.

In the absence of this credit, the value of the donated transportation would still be tax deductible. It is unclear why transportation of agricultural products should be treated more favorably than other charitable contributions.

To be considered effective, this credit must increase the amount of agricultural product donated to charitable organizations. It is not known whether this credit increases agricultural donations to charitable organizations.

Policy alternatives include increases in targeted aid (i.e., food stamps to disadvantaged individuals and government grants to charitable institutions providing food assistance).

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Young Child Tax Credit

Description:

The Young Child Tax Credit (YCTC) allows a refundable tax credit for low income working families with children younger than 6 years of age. The credit amount is $1,000 and begins to phase-out when earned income reaches $25,000 and fully phased-out when earned income reaches $30,000. The Legislature also must authorize spending funds for this credit in each state budget. Taxable year 2019, is the first year this credit could be claimed. Beginning with taxable year 2022, the credit amount will be indexed for inflation and will be expanded to taxpayers with no earned income and negative earned income.

There is no comparable federal credit.

Amount:

In tax year 2019, credits in the amount of $389 million were allowed.

Number of Tax Returns Affected:

In tax year 2019, credits were allowed on 429,000 PIT returns.

Discussion:

The Young Child Tax Credit is an anti-poverty program for both adults and children in lower income working families with young children. The primary purpose of the program is to reduce poverty among California's poorest working families and young children.

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Deduction Tax Expenditure Items

Accelerated Depreciation of Research and Experimental Costs

Description:

This provision allows taxpayers to deduct qualifying research and experimental expenditures more rapidly than the economic life of these investments.

This provision of California law conforms to federal law as of January 1, 2015, with modifications under the CTL, but does not conform to the federal Tax Cuts and Jobs Act changes relating to the amortization of research and experimental expenditures. The changes under this act are operative for amounts paid or incurred beginning in 2021.

Amount:

This program is estimated to have cost the state $138 million in tax year 2019.

Discussion:

This program's purpose is to provide taxpayers an incentive to undertake research and experimental projects. There are two reasons to encourage Research and Development (R&D). The first is that, without extra incentives, industry will typically do less R&D work than would be optimal for society. This is because R&D activity often produces "positive externalities" (i.e., benefits to people other than the person doing the R&D). Accelerated depreciation of R&D expenditures reduces the after-tax cost of R&D investments, which should lead to an increase in R&D activity.

The second reason for favorable treatment of R&D expenditures is to encourage taxpayers to do their R&D in the United States, rather than in another country. There are two possible benefits to attracting the R&D business. The first is the addition of the R&D jobs themselves. If this were the only benefit, however, the R&D industry should not be singled out for this special benefit unless R&D jobs are substantially more desirable than other jobs. The second potential benefit from attracting R&D is that other businesses may be able to adopt innovations developed locally more rapidly than they can adopt innovations developed elsewhere. If this is the case, many local businesses, not just those receiving this incentive, will gain an advantage over their rivals in other countries. This advantage is not a result of being able to obtain technological information more quickly. Given the global communications network, information can be transported across continents relatively quickly and costlessly. The advantage may come through something economists call economies of agglomeration. Economies of agglomeration are defined as "a reduction in production costs that results when firms in the same or related industries locate near one another."

Assume, for example, that the accelerated depreciation of R&D expenditures encourages some pharmaceutical companies to locate their research facilities in an area of California. This location decision, in turn, would encourage the growth of pharmaceutical research support firms (such as material suppliers, pharmaceutical manufacturers, universities doing biological and chemical research, and chemical engineers) in that area. Subsequently, with the growth of the support industries, other pharmaceutical firms will be attracted to the area. There are clearly many agglomeration economies within California (high-technology in Silicon Valley and motion pictures in Hollywood are two obvious examples). However, many factors contribute to the development and growth of agglomeration economies. Because of the complexity of agglomeration economies, the extent to which the accelerated depreciation of R&D expenditures has actually encouraged the development or growth of any agglomeration economies is not known.

It is also possible for the government to provide too large an R&D incentive. If this happens, investment will be diverted from other more productive uses to relatively inefficient R&D activities. This could hurt overall economic performance.

Other government policies supporting R&D activity include direct government grants and fellowships, indirect government support such as support for educational and other research institutions, and other tax policies such as the R&D credit, see Research and Development Expenses Credit for more detail. It is not known whether the overall level of federal support for R&D is optimal.

For R&D projects that taxpayers would have undertaken even in the absence of this provision, accelerated depreciation may be considered a windfall. The amount of R&D activity that would not have taken place if R&D accelerated depreciation was not available is not known.

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Allowance for Bad Debts Deduction

Description:

The Reserve Allowance for Bad Debts Deduction Program allows financial institutions with assets of less than $500 million who make qualified additions to their bad debt reserves to treat those additions as deductions from taxable income. Financial institutions with assets in excess of $500 million are allowed to deduct debts only as those debts are determined to be worthless. For smaller institutions, the ending balance for the bad debt reserve is determined by a formula, using historical loss ratios for the past five years and the loss ratio and loan balance for the current year. Debts that become uncollectible in the current year are charged against (subtracted from) the reserve. At the end of the year the proper balance is recalculated using the aforementioned formula. The taxpayer will then need to make an addition to the reserve to bring it up to the proper balance. This addition to the reserve is deductible. To the extent that this deduction is greater than the actual amount of bad debts written off in a given year, the bad-debt reserve allowance provides a tax benefit.

This provision of California law conforms to federal law.

Amount:

In the 2019 tax year, we estimate this program to have cost the state $500,000.

Discussion:

The Securities and Exchange Commission requires financial institutions to maintain prudent reserves for debts that likely will prove to be uncollectible. This provision lowers the cost of maintaining these reserves by allowing financial institutions to deduct increases to these reserves from income. The policy motivation for providing this favorable treatment to small financial institutions, but not to large ones, is not clear.

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Casualty Loss Deduction

Description:

This program allows taxpayers to deduct from gross income qualified casualty losses for which they were not compensated by insurance or other means. Casualty losses are “losses caused by sudden, unexpected, or unusual events, such as floods, fire, storms, earthquakes, vandalism, theft, etc.” Casualty losses are limited to nonbusiness losses that are greater than $100 per loss, and to cases where the sum of all casualty losses during a particular year is greater than 10 percent of federal adjusted gross income.

This provision of California law conforms to federal law, as of January 1, 2015, with modifications, but does not conform to the temporary federal modification to only allow a deduction for presidentially declared disasters as personal casualty losses.

Amount:

In tax year 2019, the tax impact of the casualty loss deduction claimed by PIT taxpayers was $1.2 million. The size of this tax expenditure, and the number of taxpayers affected by this tax expenditure, can vary significantly from year to year depending on the number and severity of disasters in California in any year.

Number of Tax Returns Affected:

In tax year 2019, 2,500 PIT resident returns included a casualty loss deduction.

Distribution:

Casualty Loss Deduction: 2019			
Adjusted Gross Income Class	Resident Returns Reporting Deduction (Thousands)	Amount of Deduction Claimed by Residents (Millions)	Tax Impact of Deduction* (Millions)
Less than $10,000	0.4	$14.0	$0.06
$10,000 to $19,999	0.3	$2.5	$0.00
$20,000 to $49,999	0.4	$3.0	$0.00
$50,000 to $99,999	0.7	$9.7	$0.09
$100,000 to $199,999	0.5	$11.0	$0.42
More than $199,999	0.3	$33.0	$0.63
Total	2.5	$73.2	$1.2

Source: 2019 PIT Tax Sample and Microsimulation Model
Detail may not add to total due to rounding.
*Includes part-year residents and nonresidents.

Discussion:

This program is designed to provide tax relief to taxpayers who face sudden, unexpected, or unusually large losses. The rationale for this program is that taxpayers who suffer a large loss should, for equity considerations, be allowed to reduce their taxable income by the amount of the loss. For example, if there are two taxpayers who earned $100,000 and one taxpayer suffered a $40,000 casualty loss due to a flood, while the other did not, equity considerations would suggest that the taxpayer with the loss should pay less tax. This program is effective at reducing the tax liability for taxpayers who claim the deduction, as long as they have sufficient income to offset. However, its effectiveness is limited to the extent that only taxpayers who itemize their deductions can get any benefit. Additionally, if a taxpayer's losses are larger than their income, they do not get any benefit from the loss in the current year, and the excess loss does not generate a carryforward loss that can be used in subsequent years.

An additional concern with this deduction is that, by providing relief to uninsured or underinsured losses, government indirectly discourages the purchases of home and property insurance.

Policy alternatives include providing direct relief assistance or emergency loans, or subsidizing relief organizations that perform these services.

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Charitable Contribution Deduction

Description:

This provision allows taxpayers to deduct from income cash contributions and the value of specified noncash contributions to charities, religious organizations, governmental bodies, and other qualifying nonprofit organizations. For individuals, the itemized deduction is generally limited to 50 percent of adjusted gross income. This deduction is only available to taxpayers who itemize their deductions. When taxpayers make qualified donations of appreciated property, the capital gains on the appreciated property is exempt from taxation. For corporations, in general, the deduction is limited to 10 percent of net income. Contributions that exceed these limits may be carried over for five years.

This provision of California law generally conforms to federal law. However, beginning in taxable year 2018 and before January 1, 2026, California does not conform to the federal increase in limitations for certain charitable contributions.

Amount:

In tax year 2019, PIT resident taxpayers claimed $34 billion in charitable contribution deductions, lowering their taxes by $2.8 billion. For corporate taxpayers, we estimate this deduction to have cost the state about $160 million.

Number of Tax Returns Affected:

In tax year 2019, 4.7 million PIT resident returns and about 179,000 corporation returns included a charitable contribution deduction.

Distribution:

Charitable Contribution Deduction (PIT): 2019			
Adjusted Gross Income Class	Resident Returns Reporting Deduction (Thousands)	Amount of Deduction Claimed by Residents (Millions)	Tax Impact of Deduction* (Millions)
Less than $10,000	84.8	$159.4	$1.7
$10,000 to $19,999	123.2	$230.3	$0.1
$20,000 to $49,999	665.1	$1,558.4	$21.5
$50,000 to $99,999	1,281.3	$3,937.0	$200.8
$100,000 to $199,999	1,468.7	$5,987.1	$536.0
More than $199,999	1,072.4	$21,781.6	$2,083.1
Total	4,695.5	$33,653.8	$2,843.1

Source: 2019 PIT Tax Sample and Microsimulation Model
Detail may not add to total due to rounding.
*Includes part-year residents and nonresidents.

Discussion:

The purpose of this program is to provide taxpayers an incentive to make contributions to qualifying charitable organizations. The original justification for the charitable contribution deduction at the federal level grew out of a concern that high-income taxpayers (the only individuals subject to the income tax in its early years) would have less income to contribute to charities because of the federal income tax. It was believed that charitable organizations would suffer substantial declines in income without the deduction.

The underlying reason for supporting charitable organizations is that charitable organizations provide services that benefit society as a whole. One potential problem with this rationale is that charitable organizations often work at cross purposes with other charitable organizations. For example, some charitable organizations might work to stop the development of certain portions of land, whereas other charitable organizations work to protect the rights of landowners to develop that same land. Also, much of what religious organizations do is at cross purposes from other religious organizations. Likewise, most churches (as well as synagogues, mosques, and temples) adhere to certain doctrines and work, with a greater or lesser degree of vigor, to promote the view that those doctrines are correct. How can two sets of services that contradict each other both provide a benefit to society? There are several ways to view this. One is that society benefits from most services provided by charitable organizations. While society doesn’t benefit from all the services provided by charitable organizations (such as offsetting legal advocacy), they benefit from the majority of the services or, at least, from a large enough portion of the services that it justifies the subsidy. In other words, the government may not want to subsidize all the activities of charitable organizations, but it believes that it would create more harm by attempting to distinguish which activities of charitable organizations are socially beneficial and which are not. It also may be the case that the advocacy done by charitable organizations, even when it contradicts the advocacy done by other charitable organizations, is considered healthy in the sense that it encourages competition of different political, social, and religious ideas. Just as a free market for goods can weed out inefficient producers, a free market for ideas can weed out those ideas that have insufficient efficacy or substance.[10] Finally, it may be the case that involvement in charitable organizations is considered to make the contributor a better citizen, apart from the contribution. That is, just the fact that a person aligns himself with an organization (as evidenced through a contribution) may provide that individual with an impetus to act as a better citizen (obey laws, pay taxes, treat others civilly). One possible way this could happen is by causing the individual to feel that he has a stake in at least some aspect of the community. Given that there is at least the appearance of an externality, or "benefit to society beyond the benefit realized by the giver and the receiver of the contribution," associated with charitable contributions, it is useful to ask how effective this preferential treatment for charitable contributions has been for encouraging contributions. Using reasonable estimates of the responsiveness of charitable contributions to the rate of tax suggests that, if California were to repeal the deductibility of charitable contributions, contributions would drop by 5 to 10 percent.

Even if there is a valid purpose for government to subsidize some contributions to charities, much of what falls under the guise of charitable contributions could be more accurately characterized as club dues. Those "club dues" are spent largely for the benefit of the dues-paying members. For example, when the local Little League builds new diamonds, buys new equipment, or pays into the national organization, the majority of the benefits accrue to the members of the Little League. The same could be said for most charitable organizations including religious organizations such as churches, synagogues, mosques, and temples. If the reason government subsidizes charitable organizations is the belief that club membership in itself makes people better citizens, there is no real problem with allowing the deductibility of club dues as charitable giving. However, if the justification for subsidizing charitable organizations is that they do good deeds for others outside their own organization, then the subsidy for that part of the dues that is expended internally is not well spent.

The charitable contribution deduction is only available to itemizers. Since a greater percentage of high-income taxpayers itemize, limiting this deduction to itemizers tends to treat low-income taxpayers less favorably than high-income taxpayers. Conceptually, a portion of the standard deduction is intended to account for charitable contributions by non-itemizers. Nonetheless, if a taxpayer who is taking the standard deduction makes larger contributions to a charity than another non-itemizing taxpayer, the first taxpayer will get no tax benefit from the additional contribution.

The exemption of capital gains on donated appreciated property increases the tax savings from these donations. This should increase the amount of donations to charity. To the extent that donations would have been made even if capital gains on donations were not excluded, this represents a windfall. Furthermore, this provision creates inequities between taxpayers who use different methods to make equivalent charitable donations. This occurs because some taxpayers have appreciated property to donate and others do not; therefore, some taxpayers will receive a greater tax benefit than others making the same size charitable donation.

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Circulation of Periodicals Cost Expensing

Description:

Under this program, a taxpayer can expense the costs of establishing, maintaining, or increasing the circulation of periodicals it publishes, excluding purchases of land or depreciable property. The taxpayer may instead elect to amortize the costs over a period of three years. In the absence of this program, the taxpayer would have to amortize the expenses over the period of time that the expenditure was deemed to generate income.

The provision of California law conforms to federal law.

[10] The argument against this reasoning is that if we want a free marketplace for the exchange of ideas, the government does not need to be involved in subsidizing the exchange of ideas.

Amount:

In the 2019 tax year, we estimate the cost of this program to be minor.

Discussion:

This provision encourages periodicals to increase investments related to increasing their circulation. For investments that would have been undertaken even absent of this provision, expensing provides a windfall. To the extent that taxpayers redirect funds from other investment activities to circulation-related activities, this provision creates distortions in the economy that likely are inefficient.

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Depreciation Amounts beyond Economic Depreciation

Description:

This program allows taxpayers to deduct depreciation in excess of economic depreciation on qualified physical assets.

California PIT Law conforms to the federal depreciation rules under the Modified Accelerated Cost Recovery System (MACRS) and to the rules on IRC Section 179 expensing as of January 1, 2001. California PIT Law does not conform, except for luxury autos, to the temporary bonus depreciation rules adopted by the federal government in 2002 and expanded in 2003. Beginning in taxable year 2018, California PIT Law does not conform to changes made by the Tax Cuts and Jobs Act for residential rental property where the recovery period was reduced to 30 years from 40 years for property placed in service on or after Jan. 1, 2018. The expensing and depreciation rules are set up to provide accelerated depreciation. California corporate taxpayers, however, are not allowed to follow federal depreciation rules and must use depreciation schedules that approximate actual economic depreciation.

Amount:

In the 2019 tax year, we estimate this program to have cost the state $450 million.

Discussion:

Over time, the value of old business assets decreases. Conceptually, businesses should be allowed, each year, to deduct from income the amount of the decrease (i.e., their economic depreciation). By allowing more rapid tax write-offs of equipment costs, taxpayers are allowed to recover the costs of their investments more quickly. This increases the after-tax rate of return on the depreciable property. This program's purpose is to provide an incentive for taxpayers to invest in qualified assets, such as equipment and buildings, by increasing the rate of return on these investments. It is thought that these investments will spur general economic growth both by augmenting the economy's capital infrastructure and by stimulating demand for investment goods. Neither the extent to which this provision for PIT taxpayers has increased investment in depreciable property nor the impact of any increased investment on the level of the state's economic output is known.

It has also been argued that, for some assets, accelerated depreciation compensates taxpayers for the failure of the tax code to update the depreciable basis of property to reflect inflation over time. A counter argument to this, however, is that reported earnings are not adjusted downward to reflect the impact of inflation for any other sources of capital income, such as interest or capital gains.

Accelerated depreciation will tend to benefit certain types of investments over others. As such, accelerated depreciation can have a distortionary impact on the economy and lead to inefficiencies.

Another problem with current California law is that it provides more favorable treatment to businesses subject to the PIT Law than for similar businesses subject to the Corporate Franchise Tax Law. This unequal treatment is distortionary and leads to inefficiencies.

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Employee Business and Miscellaneous Expense Deduction

Description:

A taxpayer is allowed to deduct from gross income a portion of certain unreimbursed, business-related expenses. These include business expenses such as travel, meals, entertainment, and lodging, as well as, miscellaneous expenses related to producing or collecting taxable income; management, conservation, or maintenance of income-producing property; and tax return preparation fees.

Currently, 50 percent of meals and entertainment expenses can be deducted, provided that they exceed 2 percent of the taxpayer's federal AGI. This provision of California law conformed to federal law through the 2017 taxable year. Beginning in taxable year 2018 and before January 1, 2026, federal law repeals the itemized deduction for miscellaneous expenses, but California retains the deduction.

Amount:

In tax year 2019, PIT taxpayers claimed $19.5 billion in employee business and miscellaneous expense deductions, lowering their taxes by approximately $816 million.

Number of Tax Returns Affected:

In tax year 2019, 1.5 million PIT resident returns included a deduction for employee business and miscellaneous expenses.

Distribution:

Employee Business and Miscellaneous Expense Deduction: 2019

Adjusted Gross Income Class	Resident Returns Reporting Deduction (Thousands)	Amount of Deduction Claimed by Residents (Millions)	Tax Impact of Deduction* (Millions)
Less than $10,000	109.4	$429.3	$2.6
$10,000 to $19,999	75.3	$201.3	$0.8
$20,000 to $49,999	211.1	$1,253.2	$19.1
$50,000 to $99,999	408.8	$6,143.8	$116.8
$100,000 to $199,999	432.6	$3,697.5	$234.4
More than $199,999	222.3	$7,742.4	$442.7
Total	1,459.6	$19,467.5	$816.3

Source: 2019 PIT Population File
Detail may not add to total due to rounding.
*Includes part-year residents and nonresidents.

Discussion:

The expenses covered by this provision are expenses that employees must incur in order to earn income. In our income tax system, large and unusual expenses that generate income are normally deductible. Expenses that qualify for this deduction are expenses that employers often reimburse, such as business travel. This provision, therefore, works toward restoring equity between otherwise similar taxpayers, some of whose employers reimburse these expenses and others whose employers do not reimburse them. It also creates equity between employees who are not reimbursed for their work-related expenses and the self-employed. The 2 percent floor on expenses limits this benefit to employees who incur significant business related expenses. The floor simplifies the administration of the program.

The 50 percent limitation of meals and entertainment was imposed because it was felt that many taxpayers were incurring expenditures that exceeded the legitimate business purpose of the tax favored activity. For example, there may be a valid business reason for a lunch expense. Often, the business purpose could be served by meeting at a $10 per person restaurant. The participants may, however, opt to go to lunch at a $30 per person restaurant. Conceptually, in this case, the first $10 per person should be deductible, but the remainder of the cost should be viewed as personal entertainment. The 50 percent rule is an administratively feasible method of addressing this problem.

Policy alternatives could include changing the types of qualifying expenses for this deduction or changing the 2 percent threshold for claiming the deduction. If this deduction were removed, it is possible that employers would feel pressure to either begin reimbursing their employees for these expenses or increase wages to compensate for the increased tax bill.

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Employee Stock Ownership Plans (ESOP)

Description:

This provision allows employers that provide Employee Stock Ownership Plans a deduction for dividends paid to an ESOP, when those dividends are paid by the ESOP to participants or used to retire ESOP debt. It also allows the deferral of capital gains on the sale of stock to an ESOP, if the proceeds are used to acquire a similar type of security. The deduction is not available to S corporations.

This provision of California law conforms to federal law.

Amount:

This program is estimated to have cost the state $161 million in tax year 2019.

Discussion:

This deduction provides employers an incentive to provide their employees with this form of compensation as an option. One justification often provided for encouraging ESOPs is that employees may be more productive if they are part owners of the companies that employ them. However, if employee-owned businesses are more productive than nonemployee-owned businesses, employee-owned businesses should become more prevalent even in the absence of government encouragement. In a truly competitive market, therefore, the government should not favor one form of business ownership over another.

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Individual Retirement Accounts

Description:

There are two types of Individual Retirement Accounts (IRAs): traditional IRA and Roth IRA. This provision allows taxpayers to deduct from income (subject to the limits described below) contributions to traditional IRAs. Also, earnings in traditional IRAs are excluded from income until they are distributed to the taxpayer. For Roth IRAs, contributions are not deductible. Earnings in Roth IRAs are excluded from income. Distributions from Roth IRAs are also excluded from income provided that the account has been open at least five years and the recipient is at least 59 ½ years old.

The yearly maximum contribution to IRAs is the lesser of $6,000 or 100 percent of the individual's taxable compensation for individuals less than 50 years old and $7,000 for individuals who are at least 50 years old. Married taxpayers filing a joint return may contribute to each spouse's IRA up to the maximums just described, even if one spouse receives little or no compensation. Special rules apply for California registered domestic partners. Contributions may be split between a Roth IRA and a traditional IRA but may not exceed the maximum amount contributable to a single IRA.

For 2019, the yearly limit for contributions for Roth IRAs is phased out for single taxpayers with AGI between $122,000 and $137,000, and for married filing a joint return with AGI between $193,000 and $203,000.

For traditional IRAs, if the taxpayer is an active participant in an employer-sponsored retirement plan, the yearly limit for contributions is phased out for single filers with AGI between $64,000 and $74,000, married taxpayers filing a joint return with AGI between $103,000 and $123,000, and married taxpayers filing separately with AGI between $0 and $10,000. If a married taxpayer filing a joint return is not covered by an employer's plan, but their spouse is, the deduction phases out for AGI between $193,000 and $203,000.

	2019	2020	2021
Roth IRA Contribution AGI Phase Out Range			
Single or Head of Household	$122,000-$137,000	$124,000-$139,000	$125,000-$140,000
Married/RDP Filing Jointly or Qualified Widow(er)	$193,000-$203,000	$196,000-$206,000	$198,000-$208,000
Traditional IRA Contribution AGI Phase Out Range			
Active Participant in Employer Sponsored Plan			
Single or Head of Household	$64,000-$74,000	$65,000-$75,000	$66,000-$76,000
Married/RDP Filing Jointly or Qualified Widow(er)	$103,000-$123,000	$104,000-$124,000	$105,000-$125,000
Married Filing Separately	$0-$10,000	$0-$10,000	$0-$10,000
Not a Participant in Employer Sponsored Plan, but Spouse is			
Married/RDP Filing Jointly or Qualified Widow(er)	$193,000-$203,000	$196,000-$206,000	$198,000-$208,000
Married Filing Separately	$0-$10,000	$0-$10,000	$0-$10,000

Traditional IRAs may be converted to Roth IRAs. Tax is due on the amount converted at the time of conversion. Prior to 2010, conversions were not allowed for taxpayers whose modified AGI was greater than $100,000 or married taxpayers filing separate returns.

This provision of California law conforms to federal law, with the exception of the federal AGI limitations for traditional IRAs. However, for taxable years beginning after December 31, 2017, federal law repealed the special rule permitting recharacterization of Roth conversions. Since California automatically conforms to federal deferred compensation changes, the federal repeal automatically applies to California.

Amount:

This program decreased state revenue by about $1.1 billion in tax year 2019.

Discussion:

This program's purpose is to provide an incentive for taxpayers to save for retirement.

Tax relief is provided in two ways: some relief is provided by deferral of taxes on this income and additional relief is provided to taxpayers whose marginal tax rates are lower in retirement when withdrawals are taken than they were when the taxpayer was working. The value of these benefits has been reduced by recent reductions at the federal level in the tax rate on long-term capital gains on investments held in fully taxable accounts.

The goal of this exemption/deferral is to encourage participation in retirement programs. It is hoped that participation in these programs will increase the proportion of retirees who are financially self-sufficient, rather than dependent on government aid.

Some taxpayers would save for retirement even without tax incentives to do so. To the extent that funds are transferred from other savings vehicles to tax-favored accounts, this program represents a windfall for taxpayers. The proportion of retirement funds that represent “new” savings rather than savings redirected from other sources is not known.

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Medical and Dental Expense Deduction

Description:

This provision allows taxpayers to claim a deduction for qualified medical and dental expenses incurred on behalf of the taxpayer, the taxpayer’s spouse, or the taxpayer’s dependents. Only expenditures that exceed 7.5 percent of federal adjusted gross income and not covered by other means, such as insurance, are deductible. The deduction is available only to taxpayers who itemize their deductions. Qualifying medical and dental expenses include payments for prevention, diagnosis, cure, mitigation, and treatment of disease; prescription drugs or nonprescription insulin, certain related travel and lodging costs; and qualified long-term care.

California conforms to federal tax law for this deduction.

Amount:

In tax year 2019, PIT taxpayers claimed $17 billion in medical and dental expense deductions, lowering their taxes by about $448 million.

Number of Tax Returns Affected:

In tax year 2019, approximately 1.4 million PIT resident returns included a medical and dental expense deduction.

Distribution:

Medical and Dental Expense Deduction: 2019			
Adjusted Gross Income Class	Resident Returns Reporting Deduction (Thousands)	Amount of Deduction Claimed by Residents (Millions)	Tax Impact of Deduction* (Millions)
Less than $10,000	179.6	$1,438.6	$0.5
$10,000 to $19,999	176.2	$988.6	$0.2
$20,000 to $49,999	419.4	$6,132.7	$27.7
$50,000 to $99,999	370.5	$3,960.9	$148.3
$100,000 to $199,999	193.5	$2,607.3	$181.4
More than $199,999	47.3	$1,399.5	$89.8
Total	1,386.5	16,527.6	447.8

Source: 2019 PIT Tax Sample and Microsimulation Model
Detail may not add to total due to rounding.
*Includes part-year residents and nonresidents.

Discussion:

This program is intended to mitigate hardships faced by taxpayers who incur very large medical expenses.

The tax benefit from this deduction is greater for taxpayers who are in higher tax brackets, even though those taxpayers would seemingly be more able to absorb large medical expenses. Also, this benefit is available only to taxpayers who itemize their deductions. An alternative policy that would address these issues would be to replace the deduction with either a credit or direct government compensation for medical expenses.

Another possible concern arising from this deduction is that by shifting a portion of medical expenses to other taxpayers, it may discourage some people from purchasing optimal levels of medical insurance.

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Mortgage Interest Deduction

Description:

This provision allows a taxpayer to deduct qualified mortgage interest expenses from income. Qualified mortgage interest includes mortgage interest incurred in acquiring, constructing, substantially improving, or refinancing the principal residence of the taxpayer and one other residence (e.g., a vacation home), as well as interest on home equity borrowing, secured by the residence. This deduction is only available to taxpayers who itemize their deductions.

For purchasing, constructing, or improving a home, only interest paid on the first $1 million borrowed ($500,000 for married individuals filing separate returns) may be deducted. On home equity loans, interest on the first $100,000 borrowed ($50,000 married filing separate) may be deducted. Home equity loans must be secured by a qualified residence and may not exceed the fair market value of the residence reduced by any outstanding debts incurred in the process of purchasing or constructing the home. Interest on home equity loans is deductible, even if the proceeds are used for personal expenditures.

Mortgage interest used for purposes other than buying, building or substantially improving a principal residence or other qualifying residence is not deductible in the calculation of the Alternative Minimum Tax (AMT). Therefore, taxpayers who owe AMT, and those whose credits are limited by the Tentative Minimum Tax calculation, must defer the benefits from this deduction.

This provision of California law generally conforms to federal law except for the limits on acquisition indebtedness. For tax years beginning on or after January 1, 2018 and before January 1, 2023, the federal mortgage deduction is limited to $750,000 of acquisition indebtedness for mortgages acquired after 2017. Also, interest on home equity loans is only deductible for federal purposes if the proceeds are used to buy, build or substantially improve the taxpayer’s home that secures the loan.

Amount:

In tax year 2019, PIT taxpayers claimed $60 billion in mortgage interest deductions, lowering their taxes by about $3.9 billion.

Number of Tax Returns Affected:

In tax year 2019, 4.4 million resident returns included the mortgage interest deduction.

Distribution:

Mortgage Interest Deduction: 2019			
Adjusted Gross Income Class	Resident Returns Reporting Deduction (Thousands)	Amount of Deduction Claimed by Residents (Millions)	Tax Impact of Deduction* (Millions)
Less than $10,000	121.9	$1,397.2	$1.2
$10,000 to $19,999	114.5	$1,050.3	$0.4
$20,000 to $49,999	589.7	$5,937.6	$60.7
$50,000 to $99,999	1,213.1	$12,953.8	$616.4
$100,000 to $199,999	1,420.4	$19,164.6	$1,622.5
More than $199,999	987.7	$19,587.3	$1,599.9
Total	4,447.2	$60,090.9	$3,901.0

Source: 2019 PIT Tax Sample and Microsimulation Model
Detail may not add to total due to rounding.
*Includes part-year residents and nonresidents.

Discussion:

This program's goal is to provide an incentive for home ownership. Many people believe that increasing home ownership is desirable because it promotes neighborhood stability and civic responsibility. It is thought that home ownership can do this by giving individuals a financial stake (i.e., maintaining the value of real property owned) in the neighborhood's quality.

Whether or not increasing home ownership is a valid goal, most economists believe that the value of this tax break is generally capitalized into the value of housing. In other words, on average, housing prices should increase by the expected tax savings over the time period that the house will be owned. Therefore, this deduction does not actually make housing more affordable for homeowners. Instead, it results in a transfer from the state treasury to people who already owned homes at the time the deduction was granted or, in the case of new construction, to whomever owned the land at the time it becomes obvious that the land will likely be zoned for residential use. In fact, homeowners who do not itemize or whose income places them in low rate brackets are likely to find housing less affordable, because they will not receive a tax reduction large enough to offset the increased price of housing. Additionally, if the goal is to encourage home ownership, there is no reason to extend the benefit to second homes. Another aspect of this program is that many taxpayers have used the home equity provision to engage in tax-favored borrowing for purposes other than purchasing or remodeling homes. This is done by taking out unnecessarily large loans on houses instead of taking out nontax-favored loans for other purposes.[11]

Policy alternatives that may bring this program more in line with its intended objectives include lower limits on the amount of deductible interest or limiting deductions to loans for first-time home purchases. The reduction or elimination of mortgage interest deductions could harm current homeowners in two ways. First, homeowners who itemize their deductions will lose the value of the tax deductions that they can no longer claim. This problem could be eliminated by "grandfathering" (i.e., allowing deductions for mortgages already existing when the policy changed). Grandfathering would enhance fairness by reducing the impact on taxpayers who took on mortgages under the assumption that the deduction would remain in place for the life of their loan. Of course, grandfathering would reduce the revenue gain to the state from this policy reform. Grandfathering would also create a "lock-in" effect that would reduce the efficiency of the housing market. There are two reasons for this. First, since only the current owner can claim the interest deduction, a grandfathered house is more valuable to its current owner than to a prospective buyer. Second, because the grandfathered owner can only claim the interest deduction on his

[11] Note that, as described above, while the regular PIT does not limit the deductibility (other than the overall limit on mortgage indebtedness) of home equity interest, the AMT does. Thus, many taxpayers are effectively prohibited from deducting home equity interest.

current house, the grandfathered house is more valuable to its owner than another otherwise equally valuable house. Both of these effects will distort economic activity by discouraging home buying and selling (locking owners into their current homes). Our second alternative policy, limiting deductions to first-time home purchasers, would only lock homeowners into their first homes.

The second impact of the proposed policy alternatives on current homeowners is that this policy change will likely reduce home values. We argued above that the mortgage interest deduction is generally capitalized into the value of housing. Removing or reducing the deduction should lower home prices by approximately the value of the eliminated tax benefit. Since most current homeowners purchased their homes after the implementation of the mortgage interest deduction raised housing values, most current homeowners will be unfairly harmed by this reduction in housing values.

However, it should be pointed out that, in the long run, removing the mortgage interest deduction would decrease the inequities arising from tax-driven fluctuations in housing prices. Under the current system, the tax value of the interest deduction changes every time tax rates are changed. Through the capitalization process, any increase/decrease in statutory tax rates will increase/decrease housing values, producing windfall gains/losses to homeowners. Removing the deduction will eliminate these unintended changes to wealth that results whenever tax rates change.

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Moving Expense Deduction

Description:

This program allows a deduction for the portion of qualified moving expenses required to start a new job that are not paid or reimbursed by employers. The deduction is limited to the cost of transportation of household goods and personal effects and travel (including lodging, but not meals) to the new residence. Where an automobile is used in making the move, a taxpayer may deduct either the actual out-of-pocket expenses incurred (gasoline and oil, but not repairs, depreciation, etc.) or a standard mileage allowance. Mileage rates have varied. For 2019, the rate was 20 cents per mile. For 2020, the rate was decreased to 17 cents per mile, and in 2021, the mileage rate was decreased to 16 cents per mile.

To qualify for the deduction, the move must pass two tests. The distance test requires that “the distance between the new and old locations must at least be 50 miles.” The time test requires that “the taxpayer be employed in the new job on a full-time basis for at least 39 weeks during the 12 months following the new employment.” This requirement for the self-employed is 78 weeks during the 24 months following the start of the new business.

If the employer pays the moving expense directly or reimburses the employee, that employer payment is an excludable fringe benefit to the employee as long as that expense would have been deductible, if paid directly by the employee, rather than the employer.

This provision of California law generally conforms to federal law. However, beginning in taxable year 2018, federal law suspended the moving expense deduction through taxable year 2025, except for moves by certain members of the armed forces. California has not conformed to the federal suspension, therefore, California still allows the moving expense deduction.

Amount:

In tax year 2019, resident PIT taxpayers claimed $115 million and nonresident PIT taxpayers claimed $301 million in moving expense deductions. This lowered residents’ taxes by about $6.8 million and part-year and non-residents’ taxes by about $8.4 million.

Number of Tax Returns Affected:

In tax year 2019, 39,000 resident and 65,000 part-year and nonresident returns included the moving expense deduction.

Distribution:

Moving Expense Deduction: 2019*			
Adjusted Gross Income Class	Returns Reporting Deduction (Thousands)	Amount of Deduction Claimed (Millions)	Tax Impact of Deduction (Millions)
Less than $10,000	20.7	$88.7	$0.1
$10,000 to $19,999	10.6	$31.5	$0.2
$20,000 to $49,999	27.7	$80.2	$1.9
$50,000 to $99,999	25.6	$92.8	$4.6
$100,000 to $199,999	14.2	$81.4	$5.1
More than $199,999	5.4	$41.7	$3.3
Total	104.2	$416.2	$15.2

Source: 2019 PIT Tax Sample and Microsimulation Model
Detail may not add to total due to rounding.
*Includes resident, part-year residents and nonresidents

Discussion:

The rationale behind this tax relief is that moving expenses are expenses that employees must incur in order to earn income. In our system, large and unusual expenses that generate income are normally deductible. This program creates partial parity between two taxpayers, one of whom starts a new job in a distant location and another whose new job is close to home.

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Percentage Resource Depletion Allowance Deduction

Description:

This provision allows taxpayers to deduct from income a fixed percentage for resource depletion. The percentage depends on the type of resource, and the depletion allowance cannot be more than 50 percent of a taxpayer's related net income prior to the depletion deduction, or more than 100 percent in the case of oil and gas properties.

California conforms to federal tax law regarding the percentage depletion for oil and gas wells, and for geothermal deposits. The depletion rates are limited to 22 percent for regulated domestic natural gas, 10 percent for natural gas from geopressurized brine, 15 percent for domestic crude oil and natural gas from certain independent producers, and 15 percent for geothermal deposits located in the U.S.

This provision of California law conforms to federal law.

Amount:

In the 2019 tax year, we estimate this program to have cost the state $10 million.

Discussion:

The purpose of this program is to encourage taxpayers to explore and develop oil, gas, and other mineral resources.

These increases in exploration and development activity are desirable if free market incentives, plus the federal deduction for these activities, are insufficient to induce the optimal level of business activity. There are two possible reasons this could occur. The first is that risk-averse firms may be unwilling to undertake risky and expensive exploration and development projects. This deduction may induce businesses to undertake more of these projects by increasing their expected rate of return. The large asset base of the leading natural resource firms, and their ability to diversify their risks through both financial arrangements and their ability to explore and develop multiple resource sites simultaneously, suggests that risk aversion may not be seriously retarding investment in these activities. Of course, if the government provides too great an incentive to engage in risky activity, the primary result will be an increase in this type of risky investment beyond the optimal level.

The second possible reason for government to subsidize these activities is that exploration and development of natural resources may produce externalities, benefits to society that cannot be captured by the business that generates them. The externality that one may argue arises in this case comes from a reduction in the importation of foreign natural resources. Depending on foreign resources (particularly when those foreign sources are politically unstable or unsavory) increases the risk of dramatic fluctuations in the supply and the price of these resources. These fluctuations may be very damaging to the economy. They may also induce dangerous foreign policy entanglements. On the other hand, increased exploration and development of natural resources may also generate negative externalities. For example, resource activities may cause environmental degradation. This imposes costs on all users of the environment, but these additional costs are not borne by the businesses generating them. In this case, government encouragement of these business activities may increase the overall costs to society.

The purpose of this deduction will be achieved if the deduction induces increases in exploration and development. Deductions claimed for activities that would have been undertaken even in the absence of this deduction are windfalls. The amount of qualified activity that would not have been undertaken in the absence of this deduction is not known. Since the externalities justifying this deduction are national rather than specific to California, it is not clear why California should be offering this deduction.

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Personal Property and Other Tax Deductions

Description:

This program allows taxpayers to deduct from gross income taxes on personal property paid to local and state governments. The distinction between real and personal property is that the personal property is mobile. The most common such tax is the Vehicle License Fee. Household items such as furniture and appliances are exempt from personal property taxes. City license fees, import or custom duties paid to federal customs officers, liquor or alcoholic beverage license fees, and other business, privilege, or excise taxes are also deductible under this program.

This provision of California law generally conforms to federal law. However, beginning in taxable year 2018 and before January 1, 2026, federal law limits the deduction for state and local taxes including property taxes to $10,000. California does not conform to this change.

Amount:

In tax year 2019, PIT taxpayers claimed $3.4 billion in personal property tax deductions, lowering their taxes by about $128 million.

Number of Tax Returns Affected:

In tax year 2019, 4.1 million PIT resident returns included the personal property tax deduction.

Distribution:

Personal Property and Other Tax Deduction: 2019			
Adjusted Gross Income Class	Resident Returns Reporting Deduction (Thousands)	Amount of Deduction Claimed by Residents (Millions)	Tax Impact of Deduction* (Millions)
Less than $10,000	115.2	$55.5	$0.1
$10,000 to $19,999	116.0	$56.4	$0.0
$20,000 to $49,999	601.2	$359.0	$4.2
$50,000 to $99,999	1,150.2	$1,316.4	$31.0
$100,000 to $199,999	1,293.5	$986.3	$63.1
More than $199,999	840.0	$636.3	$29.7
Total	4,116.1	$3,409.9	$128.0

Source: 2019 PIT Tax Sample and Microsimulation Model
Detail may not add to total due to rounding.
*Includes part-year residents and nonresidents.

Discussion:

This deduction most likely grew out of a view of fiscal federalism that higher-level governments should not interfere in, and perhaps should even encourage, the revenue-generating efforts of lower-level governments. Thus, the federal government encouraged lower-level governments to levy sales, property, and income taxes by allowing a deduction for these taxes. The State of California conformed to this approach partly because of the inherent benefits of conformity and partly to encourage revenue generation by county and city governments. For a variety of reasons (often arising from actions by parties with very different motivations), California has moved away from this independent approach to fiscal federalism to one where much of the revenue of local jurisdictions is actually raised by the state and then distributed to them. As such, the original motivation for this deduction may no longer be relevant. However, as is the case on the expenditure side of the budget, if a tax benefit is available for a long enough time, it comes to be viewed as an entitlement. As such, there is likely little political will, relative to the political cost, of removing this benefit.

Because it lowers taxes on personal property, this deduction may encourage the purchase of such property. The consumer response to the reduction in taxes may be particularly sensitive for automobiles because of the generally high level of political awareness of taxes on automobiles. However, it is likely, although not as likely as it is for home ownership subsidies, that any subsidies for car ownership are generally capitalized into the price of the car (i.e., the price is increased by approximately the value of the tax savings), so the purchasers are no better off than they would be without the deduction.

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Real Property Tax Deduction

Description:

Taxpayers can deduct from gross income taxes paid to local, state, or foreign governments on real property.

This provision of California law generally conforms to federal law. However, beginning in taxable year 2018 and before January 1, 2026, federal law limits the deduction for state and local taxes including property taxes to $10,000. California does not conform to this change.

Amount:

In tax year 2019, PIT taxpayers claimed $39 billion in real property tax deductions, lowering their taxes by about $2.5 billion.

Number of Tax Returns Affected:

In tax year 2019, 5.1 million resident returns included a real property tax deduction.

Distribution:

Real Property Tax Deduction: 2019			
Adjusted Gross Income Class	Resident Returns Reporting Deduction (Thousands)	Amount of Deduction Claimed by Residents (Millions)	Tax Impact of Deduction* (Millions)
Less than $10,000	153.0	$945.9	$1.7
$10,000 to $19,999	150.4	$617.0	$0.2
$20,000 to $49,999	738.4	$3,116.7	$32.0
$50,000 to $99,999	1,388.0	$6,498.3	$294.5
$100,000 to $199,999	1,567.0	$10,606.0	$839.4
More than $199,999	1,112.9	$17,094.2	$1,364.0
Total	5,109.8	$38,878.0	$2,531.8

Source: 2019 PIT Tax Sample and Microsimulation Model
Detail may not add to total due to rounding.
*Includes part-year residents and nonresidents.

Discussion:

This deduction most likely grew out of a view of fiscal federalism that higher-level governments should not interfere in, but in fact should encourage, the revenue-generating efforts of lower-level governments. Thus, the federal government encouraged lower-level governments to levy sales, property, and income taxes by allowing a deduction for these taxes. The State of California conformed to this approach partly because of the inherent benefits of conformity, and partly to encourage revenue generation by county and city governments. For a variety of reasons (often arising from actions by parties with very different motivations), California has moved away from this independent approach to fiscal federalism to one where much of the revenue of local jurisdictions is actually raised by the state and then distributed out to the jurisdictions. As such, the original motivation for this deduction may no longer be relevant.[12] However, as is the case on the expenditure side of the budget, if a tax benefit is available for a long enough time, it comes to be viewed as an entitlement. As such, there is likely little political will, relative to the political cost, of removing this benefit.

This deduction also has the effect, like the mortgage interest deduction, of subsidizing the cost of purchasing or maintaining property. Most economists believe, however, that any such subsidies are generally capitalized into the price of the property (i.e., the price increases by approximately the value of the tax savings); so that the purchaser is no better off than they would be without the deduction.

Finally, this deduction has the side benefit of offsetting some of the inequities caused by Proposition 13. Under Proposition 13, in which property values can only be adjusted 2 percent per year, unless the property is sold, homeowners who hold onto their homes for long periods of time during inflationary periods can be paying dramatically less in property taxes than their newly-arrived neighbor who is living in

[12] Note that the deduction for sales tax was repealed at the federal level in the Tax Reform Act of 1986. California conformed to this repeal in 1987. IRC Section 164 was amended to allow taxpayers since 2004 through 2009, a choice between deducting 'general sales tax' or 'state and local income tax' on their federal return; however, California did not conform to this provision.

a comparable home. This deduction partially offsets this differential by giving the person paying the higher property tax a larger deduction.

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Reforestation Expenditure Amortization

Description:

Under this program, taxpayers can amortize over seven years up to $10,000 per year of qualifying reforestation expenditures. These expenditures include the direct costs of forestation and reforestation, such as site preparation, seeds, labor, and equipment.

This treatment conforms to federal practice, except that the benefit is limited to reforestation activities located in California.

Amount:

In the 2019 tax year, we estimate this program to have cost the state $5 million.

Discussion:

The program's intent is to speed up the reforestation of depleted timberlands.

For this program to be considered effective, it must increase investment in reforestation activities. Any benefit from this program accruing to investments that would have been undertaken even in the absence of this credit would be a windfall to the taxpayer. The amount of reforestation that would not have taken place absent this credit is not known.

This tax expenditure is economically efficient only if reforestation generates positive externalities – benefits to society that are not captured by the taxpayer making the investment. This policy cannot be justified solely in terms of increased lumber available for harvest. The free market will encourage investment in reforestation sufficient to maximize profits from lumber sales. There may be a public interest in supporting reforestation, however, if society derives additional benefits from reforestation such as improved air quality, additional recreational opportunities, or offsets to greenhouse gasses.

A policy alternative would be direct government subsidies of reforestation activities.

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Self-Employed Health Insurance Premium Deduction

Description:

This provision allows self-employed taxpayers to deduct from income premiums paid for health insurance policies that they buy for themselves and their families. The deduction is limited to the taxpayer's net income earned from the trade or business for which the plan was established. The deduction can be taken regardless of whether or not the taxpayer itemizes deductions.

This provision of California law conforms to federal law.

Amount:

In tax year 2019, PIT taxpayers claimed $4.6 billion in self-employed health insurance premium deduction, lowering their taxes by $372 million.

Number of Tax Returns Affected:

In tax year 2019, 544,000 PIT resident returns included a self-employment health insurance premium deduction.

Distribution:

Self-Employed Health Insurance Premium Deduction: 2019			
Adjusted Gross Income Class	Resident Returns Reporting Deduction (Thousands)	Amount of Deduction Claimed by Residents (Millions)	Tax Impact of Deduction* (Millions)
Less than $10,000	37.9	$154.4	$0.3
$10,000 to $19,999	34.6	$122.7	$0.6
$20,000 to $49,999	107.3	$453.7	$10.3
$50,000 to $99,999	112.5	$771.9	$43.3
$100,000 to $199,999	108.5	$1,016.6	$91.5
More than $199,999	143.0	$2,076.7	$226.2
Total	543.8	$4,596.1	$372.1

Source: 2019 PIT Tax Sample and Microsimulation Model
Detail may not add to total due to rounding.
*Includes part-year residents and nonresidents.

Discussion:

The purpose of this program is to provide self-employed taxpayers an incentive to obtain health insurance for themselves and their families. The justification for this program is that self-employed taxpayers should receive the same benefit as that received by taxpayers who work as employees. Since contributions to employer provided health insurance plans are excluded from income, it is equitable to provide a similar benefit to self-employed individuals. This justification suggests that the deduction should not be limited to the net income of the taxpayer's trade or business, because taxpayers who are not self-employed may exclude employer provided premiums even if the employer is losing money. However, such an extension would substantially increase the cost to the state.

For a discussion of the desirability of providing a tax incentive to link health insurance to employment, see Employer Contributions to Accident and Health Plans Exclusion.

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Self-Employed Retirement Plans

Description:

This provision allows taxpayers to deduct from income contributions to a self-employed retirement plan (Keogh plan). The deduction claimed for California purposes must be the same as the deduction claimed for federal purposes. For defined contribution plans, in 2019 the contribution was limited to the lesser of $56,000 or 25 percent of earned income. For defined benefit plans, the deduction is limited to the maximum level required to fully fund the plan. Income generated in these accounts is also excluded from taxation until the assets are withdrawn.

This provision of California law conforms to federal law.

Amount:

In tax year 2019, PIT taxpayers claimed $4.5 billion in self-employed retirement plan deductions, lowering their taxes by about $499 million.

Number of Tax Returns Affected:

In tax year 2019, 155,000 PIT resident returns included a self-employed retirement plan deduction.

Distribution:

Self-Employed Retirement Plans Deduction: 2019			
Adjusted Gross Income Class	Resident Returns Reporting Deduction (Thousands)	Amount of Deduction Claimed by Residents (Millions)	Tax Impact of Deduction* (Millions)
Less than $10,000	1.2	$18.9	$0.1
$10,000 to $19,999	1.1	$2.5	$0.0
$20,000 to $49,999	10.4	$90.2	$3.3
$50,000 to $99,999	19.0	$252.3	$19.3
$100,000 to $199,999	35.6	$692.0	$68.0
More than $199,999	87.4	$3,473.5	$407.8
Total	154.8	$4,529.5	$498.6

Source: 2019 PIT Tax Sample and Microsimulation Model
Detail may not add to total due to rounding.
*Includes part-year residents and nonresidents.

Discussion:

This program's purpose is to provide an incentive for self-employed taxpayers to save for retirement. They are given the same type of tax deferral as individuals covered under employer-established retirement programs. Since contributions to employer provided pension plans are excluded from income, it is equitable to provide a similar benefit to self-employed individuals.

The goal of this exemption/deferral is to encourage participation in retirement programs. It is hoped that participation in these programs will increase the proportion of retirees who are financially self-sufficient, rather than dependent on government aid.

Some taxpayers would save for retirement even without tax incentives to do so. To the extent that funds are transferred from other savings vehicles to tax-favored accounts, this program represents a windfall for taxpayers. The proportion of retirement funds that represent new savings rather than savings redirected from other sources is not known.

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Student Loan Interest Deduction

Description:

Under this program, taxpayers may deduct a maximum of $2,500 for interest paid on qualified education loans. A qualified education loan is defined as "the money that is borrowed to pay for the educational expenses of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer attending post-secondary educational institutions and certain vocational schools, and institutions conducting internships or residency programs that lead to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training." The deduction is phased out based on the taxpayer's modified AGI, adjusted annually for inflation.

This provision of California law conforms to federal law.

	2019	2020	2021
Federal Modified AGI Phase Out Range:			
Single or Head of Household	$70,000-$85,000	$70,000-$85,000	$70,000-$85,000
Married/RDP Filing Jointly, Qualified Widow(er)	$140,000-$170,000	$140,000-$170,000	$140,000-$170,000

Amount:

In tax year 2019, PIT taxpayers claimed $1.1 billion in student loan interest deductions, lowering their taxes by about $91 million.

Number of Tax Returns Affected:

In tax year 2019, 1,063,800 PIT returns included a student loan interest deduction.

Distribution:

Student Loan Interest Deduction: 2019			
Adjusted Gross Income Class	Resident Returns Reporting Deduction (Thousands)	Amount of Deduction Claimed by Residents (Millions)	Tax Impact of Deduction (Millions)
Less than $10,000	44.9	$43.5	$3.6
$10,000 to $19,999	66.7	$57.0	$4.7
$20,000 to $49,999	341.2	$331.9	$27.1
$50,000 to $99,999	409.7	$449.9	$36.8
$100,000 to $199,999	200.8	$224.7	$18.4
More than $199,999	0.3	$0.5	$0.0
Total	1,063.8	$1,107.5	$90.5

Source: 2019 PIT Tax Sample and Microsimulation Model
Detail may not add to total due to rounding.

Discussion:

The goal of this program is to encourage individuals to pursue higher education. The rationale for this program, and many other programs that provide an education subsidy, is that educating individuals provides benefits to society that are not captured by the individual receiving the education. Because of this externality, the number of people seeking higher education may be less than would be best for society. Therefore, incentives must be provided to increase the number of people pursuing higher education.

The number of students who would not have opted to attend school absent this provision is not known. For students who would have taken out student loans even in the absence of this provision, this exclusion is a windfall.

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Timber Growing Costs Expensing

Description:

A taxpayer may elect to deduct up to $10,000 per year per qualified property of qualified timber growing costs incurred in California. Costs incurred in excess of $10,000 may be amortized over an 8-year period.

This provision of California law conforms to federal law.

Amount:

In the 2019 tax year, we estimate this program to have cost $10.9 million.

Discussion:

This provision is intended to encourage commercial timber production in California. Also, reforestation may provide benefits to the environment that would be undersupplied in the absence of a subsidy.

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Election Tax Expenditure Items

Head of Household and Qualifying Widow(er) Filing Status

Description:

Under the Head of Household Program, taxpayers who provide a home for a qualifying relative are eligible for a lower tax rate than is available to single persons or to married persons filing separate returns. The program provides tax relief to heads of households who are single or married but living apart.

To claim the head of household filing status, a taxpayer must provide the principal home of the qualifying relative for more than one-half of the year. In addition, the taxpayer must pay more than half of the cost of maintaining that household. Single taxpayers who provide the main home for their unmarried child or grandchild can still qualify for the head of household filing status, even if they are not entitled to a Dependent Exemption Credit for the child or grandchild. For example, if a single custodial parent has moved into the home of her widowed father, the father would qualify as a head of household. Otherwise, the taxpayer must be entitled to a Dependent Exemption Credit for the relative to be qualified.

A qualifying widow(er) is "a taxpayer whose spouse died within two years prior to the taxable year involved and has not remarried, and who provides the main home for a child for whom the taxpayer is entitled to a dependent exemption credit." Qualifying widow(er)s may claim a larger personal exemption in addition to the lower head of household tax rates.

This provision of California law conforms to federal law.

Amount:

In the 2019 tax year, we estimate this election to have cost the state $1.3 billion.

Number of Tax Returns Affected:

In tax year 2019, 2.4 million resident returns claimed head of household status and about 8,000 resident returns claimed qualifying widow(er) status.

Distribution:

Head of Household and Widow(er) Filing Status: 2019*

Adjusted Gross Income Class	Returns Reporting Status (Thousands)	Tax Impact of Status (Millions)
Less than $10,000	141.4	$0.0
$10,000 to $19,999	366.9	$0.1
$20,000 to $49,999	1,095.9	$152.6
$50,000 to $99,999	580.2	$736.6
$100,000 to $199,999	168.5	$297.6
More than $199,999	45.3	$136.9
Total	2,398.1	$1,323.8

Source: 2019 PIT Tax Sample and Microsimulation Model
Detail may not add to total due to rounding.
*Includes residents.

Discussion:

The basic structure of the income tax includes a zero percent bracket, in which the first dollars earned each year by a taxpayer are not taxed. The zero bracket is intended to recognize that a certain amount of income is vital for procuring life's basic needs. As a family increases in size, it becomes more costly to feed, house, and clothe them. The zero bracket, therefore, increases with the size of the family. For prototypical families, when a family increases in size from one member to two members, the taxpayer files a joint return instead of a single return. The joint return provides a much larger zero bracket than the single return. Subsequent increases in family size (e.g., from two members to three) increase the zero bracket only by allowing an additional dependent credit. In 2010, the tax savings from adding another type of dependent was much smaller than the savings from adding a spouse. Allowing head of household status is consistent with the view that the addition of any second member to a household, whether or not the second member is a spouse, generates a substantial increase in the most basic financial needs of the household. Lowering the tax rate for head of household filers provides less traditional two-member households with the same tax benefit level as traditional two-member households.

This favorable treatment extended to surviving widow(er)s is intended to partially compensate for the potential loss of income. This provision generates inequities between qualifying taxpayers and other taxpayers with the same income.

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Tax-Exempt Status for Qualifying Corporations

Description:

This program allows qualifying nonprofit and charitable organizations to be exempt from corporate franchise and income taxes. Qualifying corporations may include religious, political, charitable, educational, and scientific organizations, as well as, certain homeowner organizations, civic and business organizations, and credit unions.

California does not conform to the federal tax law, but instead has standalone language similar to that of the federal provision.

Amount:

This program is estimated to have cost the state $158 million in tax year 2019.

Number of Returns Affected:

In tax year 2019, 196,937 qualifying nonprofits and charitable organizations filed tax exempt returns.

Discussion:

The purpose of this program is to provide tax relief to organizations involved in nonprofit and charitable activities and for qualified membership organizations. The justification for this program is that these organizations provide beneficial services to society and, therefore, should be indirectly supported by the government. These qualifying organizations, however, are still subject to taxes for income derived from activities unrelated to their tax-exempt status.

For additional analysis of the desirability of governmental support for charitable organizations, see Charitable Contributions Deduction.

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Water's-Edge Election

Description:

Qualified corporations may elect to file on a water’s-edge basis. This election allows unitary multinational corporations to compute income attributable to California based on domestic combined reporting rather than worldwide combined reporting. Under the water's-edge provision, a business may elect to compute its California tax by reference to only the income and factors of a limited number of entities. In general, these entities include United States incorporated entities, the United States activities of foreign incorporated entities, and the activities of various foreign entities that are included in the federal consolidated return.

There is no comparable federal election.

Amount:

In the 2019 tax year, we estimate this election to have cost the state $2.6 billion.

Number of Tax Returns Affected:

In the 2019 tax year, 20,100 corporations elected to file on a water's-edge combined report basis. Of these, 17,100 were apportioning corporations and the rest were non-apportioning. There are 118,500 apportioning corporations. It is not known how many of these have foreign operations.

Distribution:

Corporations Electing to File on a Water's-Edge Basis			
Calendar Year:	**2017**	**2018**	**2019**
Apportioning Corporations	12,841	14,001	17,057
Non-Apportioning Corporations	5,726	2,961	3,044
Total	18,567	16,962	20,101

Discussion:

The worldwide unitary method is the standard method used by California to estimate the income earned in California by multistate and multinational corporations. Under this method, corporations combine their income from all operations and apportion that income to California based on the portion of a corporation's worldwide sales that are attributable to California. (Taxpayers in specified qualified industries use a formula based on the portion of the taxpayer's worldwide sales, property, and payroll that are attributed to California, rather than just the portion of sales). As an alternative, California allows corporations to elect water's-edge. The water's-edge method generally mirrors the worldwide method, but, in general, excludes foreign corporations (i.e., it considers only income from United States operations) and it apportions this income according to the portion of a corporation's United States sales that is attributable to California.

Corporations choose to elect water's-edge for a variety of reasons. Some choose water's-edge because it reduces their tax liability, others because it reduces filing complexity, and others – this group is largely composed of foreign parents – because they do not want to provide financial detail on their foreign operations to California.

The water's-edge provisions were enacted in response to concerns that the worldwide combined reporting accounting method may improperly attribute some income of multinational corporate groups to California. Worldwide combined reporting was ruled to be constitutionally permissible by the United States Supreme Court in 1983 (*Container Corporation of America v. Franchise Tax Board,* 463 U.S. 159) for United States-based businesses and in 1994 to non-United States-based businesses (*Barclays Bank PLC v. Franchise Tax Board,* 512 US 289).

Individual corporations often have very different tax liabilities under the two reporting methods. Some will owe more under worldwide combination than under water's-edge, and others will owe less. Under the elective system, many corporations will choose whichever method reduces their tax liability. Therefore, the total tax collected under the elective system is less than would be collected under either pure system. It is the election aspect of the water's-edge election that generates the tax expenditure. If all California corporations were required to use the same filing method, regardless of whether worldwide combination or water's-edge was chosen as the method, we would not consider it to be a tax expenditure.

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Exclusion Tax Expenditure Items

Agricultural Soil or Water Conservation and Prevention of Erosion Cost Expensing

Description:

This program allows taxpayers to expense qualified costs associated with soil and water conservation, and the prevention of erosion.

This provision of California law conforms to federal law.

Amount:

This program is estimated to have cost the state $4.5 million in tax year 2019.

Discussion:

This program is intended to encourage certain types of farming-related investments to encourage soil or water conservation, or to prevent erosion of land used in farming. Government encouragement for these types of investment may be necessary if these investments generate externalities, benefits to the public (in the form of a cleaner environment) that cannot be captured by the taxpayers undertaking the investment.

This program can be considered successful if it induces an increase in qualified investments. To the extent that taxpayers would have undertaken these investments even in the absence of the program, the tax relief given to this group is a windfall. The proportion of qualified investments that would not have been made in the absence of this incentive is not known.

Another potential concern is that some taxpayers might try to portray unqualified investment expenses as qualified investments. Such behavior would result in increased administrative costs to ensure compliance.

An obvious policy alternative would be a direct expenditure program providing grants to Californians making the desired types of investments. This alternative may be particularly attractive in the case of farming, since many farms operate at a loss and, therefore, may be less responsive to a tax benefit since they have no taxes to reduce.

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Basis Step-up on Inherited Property

Description:

Under this provision, when property is transferred from a decedent to an heir, the basis of the inherited property is adjusted upwards, for tax purposes, to equal its fair market value at the time of the decedent's death. Therefore, any appreciation in the property's value that occurred prior to the decedent's death is exempted from capital gains taxation.

This provision of California law conforms to federal law.

Amount:

In tax year 2019, we estimate this program to have cost the state $3.3 billion.

Discussion:

The original justification for this exemption was that since taxpayers had to pay taxes on inherited property, taxing capital gains would constitute double taxation. This concern is no longer applicable since California removed its taxes on inherited property in 1982.

Another concern is that it is sometimes very difficult for heirs to determine the original basis of the property they are inheriting. Many bequeathed assets are purchased by the deceased years prior to the year of inheritance. The heir may not know when the asset was purchased. This makes it very difficult to determine the asset's basis. Of course, recent improvements in record-keeping technology and increases in the percentage of assets held in major financial institutions should, over time, reduce the relative importance of this problem. One imperfect solution to this problem would be to provide a safe harbor basis. For example, taxpayers could be allowed to claim a basis equal to 50 percent of the sales price if they have no documentation to prove otherwise.

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Cable Company Special Apportionment

Description:

Under this program qualified cable systems can exclude 50 percent of their California sales from their apportionment factor. To qualify for the exclusion, a taxpayer must apportion their business income, derive more than 50 percent of its United States network gross business receipts from the operation of one or more cable systems and invest a minimum of $250 million for the taxable year. Qualified expenditures include any combination of tangible property, payroll, services, franchise fees, or any intangible property distribution or other rights paid or incurred by or on behalf of a member of a combined reporting group that are attributable to California.

There is no comparable federal law.

Amount:

In tax year 2019, taxpayers reduced their California net income by $3.8 billion, lowering their taxes by approximately $59 million.

Number of Tax Returns Affected:

In tax year 2019, 143 corporate returns reduced their California sales factors for qualified cable activities.

Discussion:

This program is intended to encourage cable system operators to invest in California. This program can be considered successful if it induces an increase in investments in California by the cable system operators. The extent to which qualified investments would not have been made in the absence of this program is not known. Exclusions granted to taxpayers that would have invested in California even in the absence of the exclusion may be considered windfalls.

A potential concern is that some taxpayers might try to portray unqualified investments as qualified investments in order to take the exclusion. Such behavior would result in either increased revenue loss or increased administrative costs to ensure compliance. Additionally, this program allows for an exclusion that is currently not available to other industries, the treatment of which can be construed by some to be unfair.

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Cafeteria Plan Benefits Exclusion

Description:

This program allows taxpayers to exclude qualified benefits received from cafeteria plans from gross income. Cafeteria plans are packages offered by employers that provide a choice of qualified benefits or monetary compensation. Qualified benefits may include accident and health coverage, group term life insurance coverage, or child and dependent care benefits. Qualified benefits do not include deferred compensation except for certain plans maintained by educational institutions. If the taxpayer prefers monetary compensation to qualified benefits, the monetary compensation must be included in gross income subject to taxation.

This provision of California law conforms to federal law on the definition of excludable income. California currently conforms to the federal limit on qualified amounts of income, however California has not conformed to a 2018 change in the index the federal government uses to index this limit for inflation.

Amount:

This program is estimated to have cost the state $1.8 billion in tax year 2019.

Discussion:

For the most part, the benefits (health insurance, life insurance) that can be provided on a tax-free basis through cafeteria plans can be offered on a tax-free basis without a cafeteria plan. The benefit of the cafeteria plan is that it allows employers to offer choices to their employees so that each employee can better tailor the benefits they receive to match their particular needs. In so doing, this provision is likely to encourage nonwage compensation over wage compensation. Whether this is a desirable policy goal depends on whether it is desirable to subsidize the underlying forms of nonwage compensation (health insurance, life insurance, childcare) and, if so, to what extent. For more analyses of these issues, see the relevant sections of this report. It is not known by how much the tax treatment of cafeteria plans has increased the provision of nonwage forms of compensation.

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Clergy Housing Exclusion

Description:

Clergy may exclude from gross income either the value of housing provided to them or the portion of their compensation that is designated as a housing allowance to rent or provide a home. The excludable housing allowance may not exceed the fair rental value of the home, including furnishings and a garage, plus the cost of utilities.

California conforms with modifications to the federal tax law. California does not limit the housing allowance to the fair rental value of a home.

Amount:

This program is estimated to have cost the state $32 million in tax year 2019.

Discussion:

Many clergy live on property owned by their employers. Those who live on employer-owned property benefit from the exclusion of lodging provided by their employer, see Employer Provided Meals and Lodging Exclusion for more detail. The exclusion of housing allowances for clergy provides an equivalent benefit for clergy who do not reside on employer-owned property.

This program provides tax relief to taxpayers who work for religious organizations. Presumably, religious organizations provide socially beneficial services. Providing tax relief for these employees may encourage more people to work for these organizations, thereby increasing the level of services they can provide. However, this program may lead to some economic distortions. This exclusion may cause changes to the compensation packages offered to (or demanded by) clergy that would lead to an increase in the portion of their consumption devoted to housing.

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Cost Share Payments by Forest Landowners Exclusion

Description:

State statute excludes from gross income cost share payments for the development of forest management plans received by California forest landowners from the Department of Forestry and Fire Protection or from the United States Department of Agriculture.

This provision of California law conforms to federal law under Forest Stewardship Program and the Stewardship Incentives Program pursuant to the Cooperative Forestry Assistance Act, as amended (Public Law 101-624).

Amount:

In 2019, California forest landowners received approximately $2.8 million in qualified cost sharing payments. The tax impact of this exclusion was approximately $180,000.

Discussion:

The intent of this exclusion is to encourage California forest landowners to develop long-term land management and conservation plans, implement practices that enhance the productivity of the land, and improve overall forest health.

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Coverdell Education Savings Accounts Earnings Exclusion

Description:

This program allows taxpayers to exclude from income earnings in Coverdell Education Savings Accounts (ESAs, formerly known as Education IRAs) if these earnings are spent on qualified educational expenses. Qualified expenses may be incurred at the elementary, secondary, or post-secondary level. The total yearly contributions, from all contributors, to a beneficiary's Coverdell ESA cannot exceed $2,000 per year. Qualified educational expenses include: tuition, fees, books, supplies, equipment, and room and board.

The annual contribution limit of $2,000 is available for married couples filing a joint return with modified AGI below $190,000 and $95,000 for single filers. The contribution limit is phased out for joint filers with modified AGI from $190,000 to $220,000 and for single filers with modified AGI from $95,000 to $110,000. Contributions to a Coverdell ESA are not deductible.

California conforms with modification to the federal tax law.

Amount:

In tax year 2019, we estimate this program to have cost the state $4.5 million.

Discussion:

This program provides taxpayers an incentive to save for their children’s post-secondary education by giving favorable tax treatment to earnings on qualified savings.

Some taxpayers would save for their children’s post-secondary education even without tax incentives to do so. To the extent that funds are transferred from other savings vehicles to tax-favored accounts, this program represents a windfall for taxpayers. The proportion of education funds that represent new savings, rather than savings redirected from other sources, is not known.

There are a number of other government policies that also work toward the goal of increasing participation in post-secondary education. These include direct government subsidies of colleges and universities, government aid to students for education expenses (fellowships, loans, etc.), and federal tax credits for education expenses. The program most similar to the Education IRA is Section 529, see Section 529 Account Interest Exclusion for more detail. In some cases, the interactions between these different programs greatly increase the complexity of financial planning for taxpayers expecting to send their children to college.

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Credit Union Treatment

Description:

Federal and state chartered credit unions are not taxed under state corporation law. Since these exempt organizations compete with for-profit banks and financial corporations, we consider their tax savings relative to what they would pay if they were taxed similar to for-profit organizations a tax expenditure.

Federal credit unions are specifically exempted from deferral and state income taxes under a provision of the Federal Credit Union Act. Federal law does not grant this exclusion to state-chartered credit unions. Under federal and state laws, state chartered credit unions are tax-exempt as nonprofit membership organizations and only their “nonmember” income (related business income, such as: investment income on excess/surplus deposits or ATM fees charged to nonmembers) is taxed.

Amount:

We estimate the revenue cost of the state-chartered credit unions exemption to be approximately $100 million in the 2019 tax year.

Number of Tax Returns Affected:

In 2019, there were 126 state-chartered credit unions and 284 federally-chartered credit unions.

Discussion:

This tax exemption’s purpose is to provide financial relief to institutions that provide low-cost financial and other services to their members. There are two types of credit unions: state-chartered and federally-chartered. The federal government prohibits California from taxing federally-chartered credit unions, which are also exempt from federal income tax. Extending this exemption to state-chartered credit unions places them in the same position as federally-chartered credit unions. In the absence of this exemption, some state-chartered credit unions may have opted to apply for a federal charter to obtain tax-exempt status.

To be considered successful, this provision must either increase the number of credit unions or enable these institutions to increase their banking activities. It is not known whether any of these institutions would not exist or would have curtailed their activities in the absence of this exemption.

Originally, credit union membership and business activities were narrowly limited. Over time, however, the number of credit union members and the scope of credit union activity have greatly expanded. This expansion has increased the frequency with which credit unions compete directly with commercial financial institutions. The tax advantages accruing to credit unions may enable them to attract some customers from commercial financial institutions.

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Employee Child and Dependent Care Benefit Exclusion

Description:

This provision allows taxpayers to exclude from income benefits from qualified employer-sponsored payroll deduction programs for child and dependent care services. The exclusion is also available to self-employed individuals and partners of a partnership. The exclusion is limited to the lower of $5,000 per year ($2,500 for married filing separate), the amount of the taxpayer’s earned income, or the amount of the spouse’s earned income.

This provision of California law conforms to federal law.

Amount:

In the 2019 tax year this program is estimated to have cost the state $91 million.

Discussion:

The purpose of this exclusion is to defray expenses incurred by people who must pay for child or dependent care so that they can be gainfully employed or to seek employment. This exclusion provides this relief by allowing working taxpayers to pay for childcare with pre-tax rather than post-tax dollars, thereby reducing the childcare costs by the amount of tax not paid on those dollars. Childcare expenses are a necessary part of working for many people. After subtracting the childcare expenses, an employee who has childcare expenses has less income remaining than does another employee who earns the same salary. The child and dependent care benefits are intended to make the tax burden of the employee with the childcare expenses reflective of his net (after childcare expenses) rather than gross pay.

This program successfully achieves its goal of assisting workers with their child and dependent care costs.

This exclusion could potentially induce two types of behavioral changes in taxpayers. The first is that some taxpayers who would not have chosen to seek employment if they had to bear the full financial burden of their child or dependent care may now choose to seek employment. The other is that some working taxpayers who, if the exclusion did not exist, would have made informal arrangements for child or dependent care may now choose paid child or dependent care.

This exclusion is similar to, but for many taxpayers more generous than, the Child and Dependent Care Tax Credit.

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Employer Contributions for Group Term Life Insurance Exclusion

Description:

Under this program, an employer's contribution to an employee's group term life insurance policy is exempted from the employee's gross income for the first $50,000 of the employee's coverage. The law extends the exclusion to the transfer of excess pension assets to retiree health and group term life insurance accounts.

The exemption does not apply when the beneficiary is an employer or a charitable organization, or to the cost of any group term life insurance provided under a qualified pension or profit sharing plan.

This provision of California law conforms to federal law.

Amount:

This program is estimated to have cost the state $158 million in tax year 2019.

Discussion:

This program intends to provide employers and employees an incentive to incorporate life insurance in compensation packages.

The program results in horizontal inequity. The self-employed and those employees who buy their own life insurance without receiving any employer contributions do not receive such a tax relief.

Higher-income taxpayers benefit from this program more than lower-income taxpayers. They are more likely to be granted these policies. Additionally, because higher-income taxpayers have higher marginal tax rates, they receive a larger tax reduction for each dollar of exclusion.

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Employer Contributions to Accident and Health Plans Exclusion

Description:

Under this program, employer contributions to accident and health plans are excluded from employees' gross income for tax purposes.

This provision of California law conforms to federal law.

Amount:

In the 2019 tax year, we estimate this program to have cost the state $7.1 billion.

Discussion:

This exemption provides employers an incentive to include these types of insurance as part of the employees' compensation packages. Program supporters argue that this is a desirable social goal because it provides security to workers, increases productivity, and reduces the need for the government to provide accident and health care programs. It is also sometimes argued that taxing noncash benefits imposes financial hardship on some taxpayers.

By creating large insurance pools, employer-based insurance programs may enhance the efficiency of the insurance market by mitigating a problem known as "adverse selection," which arises because people who know that they are in ill health are more likely than others to purchase health insurance. This drives up the price of insurance and, in turn, causes more people to forgo insurance. This problem is less likely to arise when employers insure large numbers of people. There are, however, a variety of nonemployer-based methods of financing health care that can also overcome the adverse selection problem.

The consensus of economists is that state and federal programs like this one have contributed significantly to shifting the mix of employee compensation from wages and salary income towards nonmonetary fringe benefits. To the extent that this is true, these programs can result in a misallocation of economic resources.

Another resource allocation problem arises from tying health insurance to employment. There are important advantages from enabling people to maintain continuity in their health insurance over time. Many people change jobs more frequently than they would like to change health plans. Establishing otherwise identical health insurance plans that are not linked to a person's place of employment would eliminate disruptions and other changes in health coverage caused by job changes (or losses). This provision in the tax code, however, provides a strong incentive to maintain employment-related health plans.

One of the most difficult issues in designing health care policy is determining the optimal level of government support for health insurance. The tax savings provided by this provision lowers the price of health care services. Lower prices will induce people to seek health care services more frequently. When this results in consumers seeking preventative health services in a timely fashion, this can further enhance the efficiency of the health care system. On the other hand, when the price of health services is too low, many people will demand to see doctors when there is no need for them to, reducing the efficiency of the system. The desirability of government-subsidized health care depends on the relative frequency of these two behavioral reactions to the subsidies.

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Employer Contributions to Pension Plans Exclusion

Description:

Subject to certain conditions, employers' contributions to qualified retirement plans and simplified employee pension plans are excluded from the gross income of employees. In addition, the earnings in these pension plans are excluded from income until they are withdrawn. Employees, however, must pay taxes upon withdrawal on the portion of the retirement benefits they receive that were funded by nontaxed contributions. For the detailed benefit plans, the exclusion is limited to the maximum level required to fully fund the plan.

This provision of California law conforms to federal law.

Amount:

In the 2019 tax year, we estimate this program to have cost the state $10 billion.

Discussion:

The goal of this exemption/deferral is to encourage participation in retirement programs. It is hoped that participation in these programs will increase the proportion of retirees who are financially self-sufficient, rather than dependent on government aid.

Some taxpayers would save for retirement even without tax incentives to do so. To the extent that funds are transferred from other savings vehicles to tax-favored accounts, this program represents a windfall for taxpayers. The proportion of retirement funds that represent new savings rather than savings redirected from other sources is not known.

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Employer Provided Education Assistance Exclusion

Description:

Taxpayers may exclude from income benefits received from an employer as part of a qualified educational assistance program. Qualified benefits may include tuition, fees, books, supplies, and equipment. The exclusion is limited to $5,250 per year.

While this provision of California law does not conform to federal law, there is a comparable federal exclusion.

Amount:

We estimate this program to have cost the state $74 million in tax year 2019.

Discussion:

This provision encourages participation in employer-sponsored educational activities.

For some employees, pursuing certain educational opportunities is a requirement of employment. For these employees, this exclusion may be viewed as similar to the exclusion of employer provided fringe benefits, see Transportation Related Fringe Benefits Exclusion for more detail. These employees would likely feel that it is unfair to make them pay additional taxes because their employer required them to enroll in educational activities.

For other employees, education funding from an employer may be viewed as similar to the receipt of a scholarship or fellowship, see Scholarship, Fellowship, and Grant Income Exclusion for more detail. This exclusion creates equity between these students and other students who receive third-party support for their education. On the other hand, it creates inequity between a student whose education is funded by a qualifying plan and one who receives nonqualified support (i.e., taxable wages) from their employer.

In general, government support for education is desirable if the education creates externalities – benefits to society that are not captured by the person incurring the cost of the activity.

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Employer Provided Meals and Lodging Exclusion

Description:

Under this provision, the value of meals and lodging provided by an employer (other than the military) to an employee, spouse, or dependent is excluded from the gross income of the employee. The meals and lodging must be provided at the employer's place of business and for the convenience of the employer. Moreover, accepting the employer provided lodging by the employee must be a precondition for the employment.

This provision of California law conforms to federal law for personal income tax purposes.

Amount:

This program is estimated to have cost the state $184 million in tax year 2019.

Discussion:

This program provides tax relief to taxpayers who are required to eat or stay at the employer's place of business to fulfill the requirements of the job. Examples are firefighters and other emergency services personnel, live-in housekeepers, and resident apartment managers.

Many employees maintain their own residence, instead of the employer provided residence (e.g., firefighters spend some nights at home and some at the station). In these cases, the value as a residence of employer provided lodging to the employee would essentially be zero, and it makes sense not to tax the employee on the nominal value of the residence. In other cases (e.g., live-in apartment managers), the employer provided residence is also the employee's primary residence. Since these employees are saving the cost of independent housing, they are receiving a benefit that conceptually should be treated as income.

If total compensation received by the employee is reduced by an amount equal to the value of this tax savings, the government is subsidizing employers who provide meals and lodging. The program may, therefore, provide an incentive for employers and employees to rely more than they otherwise would on nonwage compensation, since the after-tax value of a dollar of this form of nonwage income is greater than that of a dollar of regular taxable wage income. The extent to which compensation packages are altered because of this incentive is not known.

A policy alternative would be to establish rules to distinguish whether the employer is providing the employee's primary residence or a secondary residence and allow the exclusion only for secondary residences.

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Expensing of Intangible Drilling and Development Costs

Description:

This provision allows taxpayers to expense costs associated with the exploration and development of oil, gas, and other mineral resources. Expensing allows business entities, other than C corporations, to fully deduct the costs in the year they are incurred rather than waiting for the project to generate income. C corporations are only allowed to deduct 70 percent of their costs in the year they are incurred. The remaining 30 percent are amortized over a 5 year period starting in the month the costs are paid or incurred.

This provision of California law partially conforms to federal law. California does not allow expensing for geothermal wells.

Amount:

In the 2019 tax year, we estimate this program to have cost the state $9.6 million.

Discussion:

The purpose of this program is to encourage taxpayers to explore and develop oil, gas, and other mineral resources.

These increases in exploration and development activity are desirable if free market incentives, plus the federal deduction for these activities, are insufficient to induce the optimal level of business activity. There are two possible reasons this could occur. The first is that risk-averse firms may be unwilling to undertake risky and expensive exploration and development projects. This deduction may induce businesses to undertake more of these projects by increasing their expected rate of return. The large asset base of the leading natural resource firms, and their ability to diversify their risks through both financial arrangements and their ability to explore and develop multiple resource sites simultaneously, suggests that risk aversion may not be seriously retarding investment in these activities. Of course, if the government provides too great an incentive to engage in risky activity, the primary result will be an increase in this type of risky investment beyond the optimal level.

The second possible reason for government to subsidize these activities is that exploration and development of natural resources may produce externalities, benefits to society that cannot be captured by the business that generates them. The externality that one may argue arises in this case comes from a reduction in the importation of foreign natural resources. Depending on foreign resources (particularly when those foreign sources are politically unstable or unsavory) increases the risk of dramatic fluctuations in the supply and the price of these resources. These fluctuations may be very damaging to the economy. They may also induce dangerous foreign policy entanglements. On the other hand, increased exploration and development of natural resources may also generate negative externalities. For example, resource activities may cause environmental degradation. This imposes costs on all users of the environment, but these additional costs are not borne by the businesses generating them. In this case, government encouragement of these business activities may increase the overall costs to society.

The purpose of this deduction will be achieved if the deduction induces increases in exploration and development. Deductions claimed for activities that would have been undertaken even in the absence of this deduction are windfalls. The amount of qualified activity that would not have been undertaken in the absence of this deduction is not known. Since the externalities justifying this deduction are national rather than specific to California, it is not clear why California should be offering this deduction.

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Federal Government Obligation Interest Exclusion

Description:

Interest earned on debt issued by the federal government is exempt from income tax.

Federal law directs the taxation of this provision.

Amount:

In tax year 2019, the amount of federal obligation interest excluded from PIT returns was $2.1 billion. The tax impact of this exclusion was $224 million.

Number of Tax Returns Affected:

In tax year 2019, 230,000 resident and 69,000 part-year or nonresident PIT returns included the federal obligation interest exclusion.

Distribution:

Federal Obligation Interest Exclusion: 2019			
Adjusted Gross Income Class	Resident Returns Reporting Exclusion (Thousands)	Amount of Exclusion Claimed by Residents (Millions)	Tax Impact of Exclusion* (Millions)
Less than $10,000	13.8	$138.8	$2.7
$10,000 to $19,999	9.1	$44.5	$1.3
$20,000 to $49,999	28.3	$87.1	$3.8
$50,000 to $99,999	43.7	$166.2	$11.1
$100,000 to $199,999	52.8	$198.1	$19.0
More than $199,999	82.4	$1,456.8	$185.9
Total	230.0	$2,091.5	$223.8

Source: 2019 PIT Tax Sample and Microsimulation Model
Detail may not add to total due to rounding.
*Includes part-year residents and nonresidents.

Discussion:

Federal statutes prohibit states from imposing an income tax on interest income from federal debt obligations.

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Foster Care Payment Exclusion

Description:

Under this provision, taxpayers are allowed to exclude from income the payments they receive from state and local governments, as well as tax-exempt foster care placement agencies, as reimbursements for the costs of caring for a foster child. The foster child must live in the taxpayer's home for the exclusion to apply.

Also excluded from the income of foster parents are the supplemental "difficulty of care payments" paid by the state or a tax-exempt child placement agency. These are additional payments to compensate the foster parents for the care of a foster child with a physical, mental, or emotional handicap.

This provision of California law conforms to federal law.

Amount:

In the 2019 tax year, we estimate this program to have cost the state $23 million.

Discussion:

The rationale for this program is to provide taxpayers incentives to care for foster children. Allowing foster care payments to be nontaxable increases the value of the payments to the recipients. Because of the progressive tax rate structure, the increase in the value of payments is greater for higher-income taxpayers than for lower-income taxpayers. If this tax preference were removed, the state could increase foster care payments to restore the average value of payments to foster parents. If payments were raised, then the net effect on state revenues would be minimal, but there would be some redistribution of resources from higher-income to lower-income foster parents.

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In Home Supportive Services Payment Exclusion

Description:

Under this provision, taxpayers are allowed to exclude from income the compensation they receive from the state for the care of an individual who needs care by reason of a physical, mental, or emotional handicap. These "difficulty of care payments" are also offered to foster parents and paid by the state or a tax-exempt child placement agency.

This provision of California law conforms to federal law.

Amount:

In the 2019 tax year, we estimate this program to have cost the state $23 million.

Discussion:

The rationale for this program is to provide eligible individuals in need of care with services that allow them to live safely in their own home. Allowing "difficulty of care" payments to be nontaxable increases the value of the payments to the recipients. Because of the progressive tax rate structure the value of payments is greater for higher-income taxpayers than for lower-income taxpayers. If this tax preference were removed, the state could increase difficulty of care payments to restore the average value of payments. If payments were raised, then the net effect on state revenues would be minimal, but there would be some redistribution of resources from higher-income to lower-income caregivers.

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Injury and Sickness Compensation Exclusion

Description:

This provision allows taxpayers to exclude from income the compensation received from workers' compensation, accident insurance, and health insurance for their physical injuries and physical sickness. The exclusion applies whether the compensation is awarded by court order or whether the taxpayer receives the award in lump sum or installment payments. In addition, reimbursement by the employer for expenses incurred for the care of an employee, the employee's spouse, or the employee's dependents is not subject to taxation. On the other hand, punitive damages are taxable since they are amounts in excess of what is necessary to "make the taxpayer whole." Disability benefits received under state statutes are excludable, but reimbursements for medical expenses claimed as income tax deductions in prior years are not.

This provision of California law conforms to federal law.

Amount:

In the 2019 tax year, we estimate this program to have cost the state $82 million.

Discussion:

This program provides tax relief to qualified taxpayers who suffer economic hardship resulting from injuries or sickness. This program acts as a type of insurance. This type of insurance program may address two types of hardship: the first is loss of income when injury or sickness prevents a person from working; the second is direct expenses (primarily medical) arising from injury or sickness.

In the first case, if the replacement income from the insurance equals the income lost due to injury or sickness, this exclusion creates inequities. This happens because a taxpayer who receives insurance payments will have a higher after-tax income than another taxpayer who earned an identical income prior to the first taxpayer's injury. In this case, the insurance income should be taxed as if it were regular income. If, on the other hand, insurance payments are less than or equal to the after-tax income that the taxpayer would have had in the absence of the injury; the exclusion works to restore equity between these taxpayers.

To the extent that this exclusion compensates taxpayers for direct expenses related to their injury or sickness, it creates inequities between taxpayers receiving deductible compensation and others who suffer the same injuries or illnesses but receive no tax break. Furthermore, because this is an exclusion, the actual benefit conferred is greater for taxpayers in higher income brackets, even though those people may be more able to withstand the financial hardship caused by the injury or sickness. A policy alternative would be direct government expenditures for medical and other related expenses.

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Life Insurance and Annuity Contract Proceeds Exclusion

Description:

These provisions allow taxpayers to exclude from gross income proceeds received from a deceased person's life insurance policies. In accordance with a reclassification made by the Joint Committee on Taxation, the interest component of proceeds received on life insurance and annuity contracts in circumstances other than death is no longer considered a tax expenditure.

This provision of California law conforms to federal law.

Amount:

In the 2019 tax year, we estimate this program to have cost the state $643 million.

Discussion:

This program's purpose is to provide tax relief for those who receive benefits as designated beneficiaries of a deceased person's life insurance policies. The rationale for this program is that beneficiaries often face economic hardships due to the loss of income and/or services provided by the deceased and, thus, need an additional benefit.

Alternative policy would be to address the specific financial hardships involved, rather than to favor life insurance as a vehicle for financing them (e.g., the government could provide direct expenditures for items such as funeral expenses or childcare for children who lose a parent). Direct expenditures could be provided to all who are in need, not just to those who receive life insurance (and, hence, are less likely to be severely financially distressed).

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Like-Kind Exchange Capital Gain Deferral

Description:

Under this program capital gains and losses are not immediately recognized for exchanges of qualifying property. Qualifying property is business or investment property exchanged for similar (like-kind) property. If, as part of the exchange, other property (not like-kind) or money is received, gain is recognized on the other property or money received. In a like-kind exchange, the unrecognized gain or loss typically carries over into the new asset. When the new asset is sold or exchanged in a taxable transaction, the realized gain or loss from the first transaction would then be recognized. The nonrecognition rule does not apply to exchanges of inventory, stocks, bonds, notes, other securities or evidence of indebtedness, or certain other assets. Also, the like-kind exchange rules do not apply to exchanges of property the taxpayer uses for personal purposes.

This provision of California law conforms to federal law with modifications. When California property is exchanged for property outside of California, California requires the taxpayer to file an annual report on the non-California property in order to maintain the nontaxability of the exchange. Beginning in 2018, Federal law limited the exclusion to the sale of real property. California conforms to this limitation beginning in 2019 with slight modifications.

Amount:

In tax year 2019, we estimate this program to have cost the state $1.2 billion.

Discussion:

This program's purpose is to facilitate exchanges of business or investment assets. The deferral of gains on like-kind transactions affords owners of exchanged property the same tax treatment as owners of other similar property that has not been exchanged. Absent the deferral, some transactions may not be undertaken in order to avoid paying tax on the gain. This gain avoidance could result in both inefficient portfolio choices for some investors and an inefficient allocation of investments across investors. On the other hand, the deferral results in different tax treatment for taxpayers who exchange qualified property and those who exchange property that is not qualified. This differential may result in economic distortions by encouraging excessive investment in qualified properties.

By allowing investors to retain lower bases for their investments, the deferral for like-kind exchanges also increases the cost of the step-up in basis at death, see Basis Step-up on Inherited Property for more detail.

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Limited Partnership Investment Source Rules

Description:

This program exempts dividends, interest, or gains and losses from qualified investment securities of members of limited partnerships from tax - if the members reside outside California and their only contact with this state is through a security dealer, broker, or an investment advisor located in the state. Qualified investment securities include, but are not limited to, stocks, bonds, and mortgage-based or asset-backed securities.

This provision of California law does not conform to federal law.

Amount:

In the 2019 tax year, we estimate this program to have cost the state $13 million.

Discussion:

The purpose of this provision is to encourage nonresident investors to use California investment services. Prior to passage of this exemption, nonresident members of limited partnerships were deemed "doing business" in California, and were taxed on their security investment income if the investments had been made through a California dealer or broker. The securities industry argued that these tax rules placed the California investment services industry in a competitive disadvantage vis-à-vis their competitors in states that granted this exemption.

This provision can be considered successful if it increases the amount of nonresident security investments made through California brokers and if the economic value to California of these investments exceeds the value of the forgone revenue. It is not known how much current investment qualifying for this exemption would have taken place elsewhere if this exemption did not exist.

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Miscellaneous Fringe Benefits Exclusion

Description:

Under this program, employees receive tax exemption for certain fringe benefits paid by their employers. These benefits include:

- Free special services provided to employees (such as free standby flights provided by airlines to their employees).
- Employee discounts for the purchase of company products.
- Use of company equipment (such as a company car).
- “De minimis” fringe benefits (such as personal use of an employer’s computer equipment or the use of on-premise gymnasium facilities).

This provision of California law conforms to federal law as of January 1, 2015, and therefore, does not conform to the temporary changes made by the Tax Cuts and Jobs Act.

Amount:

In the 2019 tax year, we estimated this program to cost the state $361 million.

Discussion:

The rationale for the tax relief depends on the type of the benefit. For example, in the case of the use of gymnasium facilities, one can argue that using such facilities improves the health, morale, and productivity of employees; therefore, this expense can be viewed as a business investment. In other cases, such as personal use of company equipment, the administrative difficulty of measuring the private benefits of the use of the equipment (business use of the equipment should not be taxed) for tax purposes is the primary justification.

This exemption increases the value to employees of these miscellaneous fringe benefits relative to wages. Therefore, this exemption encourages the provision of compensation in the form of miscellaneous benefits. The extent to which this exemption increases the amount of these benefits given to employees is not known. Repeal of these exemptions would likely increase administrative and compliance costs significantly.

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Nonresident Military Pay Exclusion

Description:

Nonresident military pay is exempt from state income taxes. For purposes of federal law, income earned by the non-military spouse of a nonresident service member serving in California in compliance with military orders is also exempt if they both have the same domicile. In addition, a nonmilitary spouse of an active duty servicemember may elect to use the same residency as the service member for tax purposes. All other nonresident service member’s California source income is subject to California tax.

This provision of California law does not conform to federal law.

Amount:

In the 2019 tax year, we estimate this program to have cost the state $71.4 million.

Number of Tax Returns Affected:

The number of nonresident tax returns excluding pay under this provision is approximately 70,000.

Discussion:

Federal statutes prohibit states from imposing an income tax on nonresident military pay and provides rules on the determination of residency and domicile for spouses of active servicemembers. The purpose is to prevent sudden changes in taxes on servicemembers and their families caused by military deployments and redeployments. Subjecting the servicemember and their spouse to tax changes due to their residency, is viewed by many as unfair because it is outside of the taxpayer's control and may occur frequently and on short notice. This program may be considered successful if it reduces the uncertainty and complexity of a servicemembers' taxes.

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Sale of Principal Residence Capital Gain Exclusion

Description:

Under this provision, the gain realized on the sale or exchange of a principal residence, up to $250,000 for single filers and $500,000 for joint filers, is excluded from taxation. The property must have been used as a principal residence in two of the previous five years. Taxpayers who do not meet the ownership and use requirements may still qualify for a reduced exclusion amount. To qualify, they must show that the sale or exchange is due to a change in employment, health, or in some cases, unforeseen circumstances. The exclusion can be applied multiple times during a taxpayer's life, but only to one sale or exchange every two years.

This provision of California law conforms to federal law with modifications. Under California law, the two-year period of use can be reduced by as much as 18 months for Peace Corps volunteers.

Amount:

In tax year 2019, we estimate this program to have cost the state $3.5 billion.

Discussion:

In the absence of this provision, the capital gains generated by sales of homes would receive the same tax treatment as other types of capital gains.

There are a number of reasons why many taxpayers would view this as unfair. Opposition stems partly from the psychology of home sales. Home sales are often traumatic experiences even without tax considerations. The gains from home sales are often very large relative to the seller's other income, so the tax due if housing sales were treated like other gains may appear unfairly large relative to the taxpayer's non gain income. This feeling is exacerbated by the fact that, because the income tax is progressive, fully taxing gains on home sales would push many taxpayers into a higher tax bracket. Another psychological complication arises from the fact that most home sellers purchase another home at approximately the same time as the sale of the first home. When a taxpayer moves to a more expensive home, they generally feel as though they have taken on a new financial burden, not as though they have generated a capital gain. The capital gains exclusion for sales of residences is an effective response to the perceived injustice of fully taxing these capital gains.

This provision encourages people to buy and sell houses more often. Many sellers of primary residences purchase another house at approximately the same time that they sell their house. Some homeowners would choose to stay in their original house, rather than sell it and buy a new one, if they had to pay capital gains on the sale of their first house. This lock-in effect would reduce the efficiency of the housing market.

The exclusion also increases the rate of return on investments in housing. This should increase the amount of investment in the housing sector. This may result in an increase in the number of people who own their own home or, as most economists believe, the value of the tax break may be capitalized in the value of housing (i.e., on average, housing prices are increased by the value of the tax break), so houses are not more affordable than they would be in the absence of this exclusion.

A policy alternative would be to tax capital gains on houses the same as other capital gains. A more refined policy would allow the capital gain to be rolled over when a more expensive house is purchased at approximately the same time as the gain-generating sale. This would solve the lock-in problem in which taxpayers opt not to sell and buy houses, because the tax on the sale deprives them of resources necessary for the purchase of the next house.

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Scholarship, Fellowship, and Grant Income Exclusion

Description:

This provision allows taxpayers to exclude from income any qualifying scholarships, fellowships, and grants received and used for qualified educational expenses at an educational institution. Qualified expenses include tuition, enrollment fees, books, supplies, and equipment. The exclusion also applies to incidental expenses such as travel, research, clerical assistance, and equipment.

This provision of California law partially conforms to federal law.

Amount:

In the 2019 tax year, we estimate this program to have cost the state $162 million.

Discussion:

This program provides an incentive for taxpayers to pursue education. This may be sound public policy if society as a whole benefits from having more individuals pursuing higher education. It is not known; however, how many students would forgo these educational pursuits in the absence of this exclusion. In fact, since many colleges calibrate student aid levels to the financial needs of their students, the colleges might increase aid levels for the neediest students if the exclusion was removed. It may not, therefore, be possible to assess the overall impact of this exclusion without studying the entire higher education funding system.

This system includes:

- Both direct government subsidies to educational institutions.
- Government-backed student loans.
- Other tax preferences, such as:
    - The exclusion of savings in education IRAs, see Coverdell Education Savings Accounts Earnings Exclusion.
    - Section 529 plans, see conformity item Section 529 Account Interest Exclusion.
    - The exclusion for employer provided educational expenses, see Employer Provided Education Assistance Exclusion.
    - Federal education credits (Hope Credits and Lifetime Learning Credits).

Prior to 1954, these items were included in income unless the taxpayer could demonstrate that the funds constituted a gift. Some observers argued that it was inequitable to tax some students, but not others, on their expenses.

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Section 529A (ABLE) Account Interest Exclusion

Description:

This program allows taxpayers to exclude from income earnings in an IRC Section 529A Achieving a Better Life Act (ABLE) savings accounts (such as California's ABLE Program, CalABLE). Both earnings and withdrawals are tax free for both federal and California purposes, provided the funds are used to pay for qualified disability related expenses for the designated beneficiary of the account. In addition, savings in ABLE accounts do not count towards savings caps on eligibility for other public benefits such as Supplemental Security Income/State Supplementary Payment (SSI/SSP), CalFresh and Medi-Cal.

Distributions not used for qualified disability expenses are subject to an additional 2.5 percent tax. For taxable years beginning on or after January 1, 2017, the residency requirement for a designated beneficiary was expanded to include residents of the United States.

This provision of California law conforms to federal law with modifications.

Amount:

In tax year 2019, the cost to the state for this program is estimated to be minor.

Discussion:

This program is intended to mitigate financial hardships faced by people with disabilities. The program is complementary to several other public benefits programs with similar objectives. Programs such as Supplemental Security Income/State Supplementary Payment (SSI/SSP), CalFresh, and Medi-Cal, have eligibility requirements which often don't allow the recipient to accumulate significant savings. Since ABLE accounts do not count towards the eligibility limits for these other programs, they enable those with disabilities to save for the future. In addition, this program provides taxpayers an incentive to provide resources to disabled beneficiaries by giving favorable tax treatment to earnings on qualified savings.

This program can be considered successful if it increases the resources available to people who incur extra expenses because of their disabilities. It may be inefficient if, in combination with other programs aiding those with disabilities, it induces transfers larger than the excess expenses incurred because of disabilities. A policy alternative would be redesigning to a direct expenditure programs providing grants to disabled Californian's and families raising a child with disabilities to provide aid to all who are in need, regardless of their ability to save.

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Section 529 Account Interest Exclusion

Description:

Taxpayers may exclude from income earnings of IRC Section 529 educational savings accounts (such as California's Scholarshare Program), provided that, upon withdrawal, the money is used for qualified educational expenses.

This provision of California law conforms to federal law with modifications. As of 2018, federal law allows education expenses to include elementary school and secondary school tuition, California does not. Under Chapter 557, Statutes of 2021, California conformed to additional changes made by The Further Consolidated Appropriations Act, 2020, to allow tax-free treatment for distributions for higher education expenses for the participation of a designated beneficiary in an apprenticeship program for tax years beginning on or after January 1, 2021.

Amount:

This program is estimated to have cost the state $58 million in tax year 2019.

Discussion:

This program provides taxpayers an incentive to save for their children's post-secondary education by giving favorable tax treatment to earnings on qualified savings.

Some taxpayers would save for their children's post-secondary education even without tax incentives to do so. To the extent that funds are transferred from other savings vehicles to tax-favored accounts, this program represents a windfall for taxpayers. The proportion of education funds that represent new savings rather than savings redirected from other sources is not known.

There are a number of other government policies that also work toward the goal of increasing participation in post-secondary education. These include direct government subsidies of colleges and universities, government aid to students for education expenses (fellowships, loans, etc.), and federal tax credits for education expenses. The program most similar to Section 529 is the Education IRA, see Coverdell Education Savings Accounts Earnings Exclusion, for more detail. In some cases, the interactions between these different programs greatly increase the complexity of financial planning for taxpayers expecting to send their children to college.

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Social Security Benefits Exclusion

Description:

This provides an exclusion from gross income for payments received from the Social Security Administration.

This provision of California law does not conform to federal law; however, there are also portions of social security benefits excluded from taxation at the federal level.

Amount:

In tax year 2019, taxpayers excluded $35 billion in social security income from their California PIT returns that was reported and taxable on their federal income tax returns. We estimate the tax impact of this exclusion of social security income to have been $2.3 billion. However, a large portion of social security income, particularly for low-income and middle-income taxpayers, is not taxable at the federal level either and not reported on federal income tax returns. Accordingly, the total amount of social security income excluded from California PIT returns is not known. We estimate the total impact of not taxing social security income at the state level to have been about $4.0 billion for tax year 2019.

Number of Tax Returns Affected:

In tax year 2019, 2.1 million PIT returns excluded social security income that had been reported on their federal tax returns. The number of taxpayers who had social security income but were not required to report it on either their federal or California returns is not known.

Distribution:

Exclusion of the Portion of Social Security Income Reported on Federal Tax Returns: 2019**

Adjusted Gross Income Class	Resident Returns Reporting Exclusion (Thousands)	Amount of Exclusion Claimed (Millions)	Tax Impact of Exclusion* (Millions)
Less than $10,000	16.9	$145.1	$0.6
$10,000 to $19,999	129.6	$320.7	$0.9
$20,000 to $49,999	751.5	$8,062.8	$249.9
$50,000 to $99,999	613.1	$12,657.3	$777.0
$100,000 to $199,999	375.5	$8,569.4	$751.4
More than $199,999	193.5	$5,366.5	$528.8
Total	2,080.2	$35,121.7	$2,308.7

Source: 2019 PIT Tax Sample and Microsimulation Model
Detail may not add to total due to rounding.
*Includes part-year residents and nonresidents.
**Only some portions of Social Security income are required to be reported on federal tax returns. The data reported here represents the number of Californians with Social Security income that was reported on their federal tax return, the amount of Social Security income reported on their federal returns and excluded on their California return, and the related tax impact.

Discussion:

Reducing the tax liability of social security recipients is the primary goal of this exclusion. The exclusion is successful in achieving this purpose.

Social Security is a vehicle for two types of income flows: pension savings and poverty relief. When Social Security first came into existence, the poverty rate for seniors was substantially higher than the overall poverty rate in this country. One goal of the Social Security system is to ensure a minimum level of income support for all participants. To achieve this goal, social security payments are more generous than contributions for many low-income participants. To the extent that social security payments represent poverty relief, it makes sense to exclude these payments from income, just as other types of welfare payments are excluded from income.

Social security payments also contain a pension plan component that should not be viewed as poverty relief, but rather as a return on contributions invested in the Social Security system. Appropriate tax policy would treat the pension plan component of social security payments the same as other pension income. The comparison between Social Security and other pension plans is complicated by the split contribution system used by Social Security. Some social security contributions are made by employers and are not taxed. Employees make other contributions from after-tax income. It would, therefore, be appropriate to exclude from income benefits equal to the amount of contributions that have already been taxed. Other social security benefits should be included in income. However, since they are not, the exclusion of social security from AGI has a negative impact on horizontal equity. Consider two taxpayers, both receiving $40,000 this year. One earns $40,000 in investment interest. The other earns $20,000 in interest and receives $20,000 from Social Security. With California's current treatment of social security benefits, the first taxpayer will have to pay tax on the entire $40,000 of interest, while the other taxpayer will only pay tax on the $20,000 of interest received. One potential problem that is eliminated by this exclusion is that the taxation of social security benefits may dissuade some recipients from seeking or retaining employment. This is because the inclusion of social security benefits would push employed recipients into higher marginal tax brackets, reducing the incentive for them to work.

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State and Local Government Obligation Interest Exclusion

Description:

Interest earned on debt issued by California State and local governments is exempt from income tax.

This provision of California law conforms to federal law. However, California does not exclude interest income earned from debt obligations issued by state and local governments outside California. California law does not exclude interest income earned from these obligations by corporations that pay the franchise tax.

Beginning in taxable year 2018 and before January 1, 2026, California is no longer in conformity with federal changes on rules for exclusion from gross income for advance refunding bonds, rules relating to exemption of interest earned on state or municipal bonds, and California has not adopted the federal private activity bond rules.

Amount:

In the 2019 tax year, we estimate this program to have cost the state $1.1 billion.

Discussion:

The California Constitution exempts from income the interest on debt issued by the state or by local governments in California. This provision is intended to reduce the costs of borrowing by state and local governments in California. The extent to which the provision lowers borrowers' costs rather than increasing gains to bond purchasers is not known.

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State Lottery Winnings Exclusion

Description:

Under this provision, winnings from the California State Lottery are exempt from gross income.

There is no comparable federal exclusion.

Amount:

In tax year 2019, the amount of exempt income was approximately $744 million. We estimate the tax impact of the exclusion at $74 million.

Number of Tax Returns Affected:

In tax year 2019, approximately 19,400 California PIT returns included lottery income on their federal tax returns and excluded the income from their PIT returns.

Distribution:

California Lottery Winnings Exclusion: 2019			
Adjusted Gross Income Class	Resident Returns Reporting Exclusion (Thousands)	Amount of Exclusion Claimed (Millions)	Tax Impact of Exclusion (Millions)
Less than $10,000	2.9	$88.0	$6.5
$10,000 to $19,999	1.8	$51.7	$4.6
$20,000 to $49,999	5.2	$66.3	$5.1
$50,000 to $99,999	4.8	$122.7	$13.0
$100,000 to $199,999	3.1	$43.7	$3.7
More than $199,999	1.5	$371.3	$41.5
Total	19.4	$743.7	$74.4

Source: 2019 PIT Tax Sample and Microsimulation Model
Detail may not add to total due to rounding.

Discussion:

Proposition 37, the California State Lottery Act of 1984, established the California State Lottery. The Act prohibits California from taxing winnings from the California State Lottery. This exemption differs from both federal tax treatment of lottery winnings and from California treatment of other gambling winnings. State lottery winnings are subject to federal income taxation, to the extent they exceed lottery-wagering losses. Gambling winnings other than lottery winnings are subject to both state and federal income taxation, to the extent that they exceed gambling losses.

The purpose of this exemption is to encourage sales of California State Lottery tickets. This is considered desirable because a portion (34 percent) of lottery sales is used to fund education programs. Lottery proceeds account for only two percent of education expenditures, however, to be considered effective, this exemption must increase lottery sales by at least three times the amount of forgone revenue. This is because only one-third of the revenue from lottery sales goes to education programs. The rest goes to prizes and administrative expenses. Therefore, the loss of funds to education programs will be only one-third of the decrease in lottery sales attributable to making them taxable. By contrast, in the absence of this exemption, all of the revenue raised from taxes on lottery income could be directed to education. The extent to which lottery sales might decrease if this exemption were removed is not known.

Additionally, it is not clear whether the lottery funds that are contributed to public education ultimately affect the amount of money spent on education. Although lottery funds are earmarked for education, there is nothing to keep those who are setting education funding levels from considering the earmarked funds as part of the total funding level. That is, if the state legislature decides that the appropriate amount of money to devote to public education is $28 billion, and it knows that $1 billion is earmarked from the lottery, it can adjust the contribution from the General Fund to $27 billion. However, with the 1988 adoption of Proposition 98, School Funding for Instructional Improvement & Accountability, it could become more difficult to shift lottery funds from education to other uses. Proposition 98 set minimum funding levels for education, independent of lottery funds. Thus, if Proposition 98 funding limits are binding (i.e. if the state is not funding education above the minimum levels specified by Proposition 98), the lottery funds would truly be augmenting the state's funding of education. However, when the state contributes more to education than required by the Proposition 98 minimums, it is possible and, one might argue, reasonable for legislators to consider the lottery contribution when determining the General Fund contribution to public education.

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Transportation Related Fringe Benefit Exclusion

Description:

This provision allows employees to exclude qualified compensation for employer provided transportation benefits from wage income. For 2019, the amount of excluded benefits includes up to $265 per month for parking, $265 per month for transit passes and commuter highway vehicle transportation, $20 per month for qualified bicycle commuting, and all expenses for ridesharing programs. The exclusion is limited to the fair market value of the benefits received.

These provisions of California law generally conform to federal law, except that in California law, the exclusion for ridesharing is more generous. For federal purposes, the ridesharing exclusion is limited to $265 per month in 2019. For tax years beginning January 1, 2018, and before January 1, 2026, the federal exclusion for employer provided bicycle commuter benefits was suspended; whereas, for California, the exclusion is unlimited, and the $20 per month bicycle compensation is allowed in 2019. Also, for taxable years beginning January 1, 2018, and before January 1, 2026, federal law does not allow businesses offering these benefits to deduct their cost. Since these amounts are taxed to business, these benefits should not be considered tax expenditures at the federal level for these years.

Amount:

In the 2019 tax year, we estimate this program to have cost the state $280 million.

Discussion:

There is no obvious policy reason for the exclusion of employer provided parking benefits.

Favorable tax treatment for mass transit and ridesharing can be justified on the grounds that encouraging alternative forms of transportation may reduce congestion and air pollution.

The purpose of the more generous California exclusion for ridesharing is to encourage ridesharing. To the extent that ridesharing reduces the number of cars on California roads (especially if the reductions occur during commute times); both roadway congestion and air pollution will be reduced.

This program will be considered successful if it increases ridesharing. The number of taxpayers who currently utilize ridesharing programs, but wouldn't absent this provision, is not known. The reduction in congestion from subsidized ridesharing programs could encourage some people to choose to live further from their jobs and undertake longer commutes, thus reducing the gains from the ridesharing program.

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Unemployment Insurance Benefits Exclusion

Description:

This provides an exclusion from gross income for benefits received under the state's unemployment insurance program. Privately-provided unemployment benefits are not taxable up to the amount of prior contributions, but benefits that exceed prior contributions are taxable. By contrast, government-provided unemployment benefits are not taxable, whether they exceed previous contributions or not.

This provision of California law does not conform to federal law.

Amount:

In tax year 2019, the amount of unemployment income excluded from PIT returns was $4.6 billion. The tax impact of this exclusion was $167 million.

Number of Tax Returns Affected:

In tax year 2019, this exclusion affected 900,000 PIT returns.

Distribution:

Unemployment Compensation Benefits Exclusion: 2019			
Adjusted Gross Income Class	Resident Returns Reporting Exclusion (Thousands)	Amount of Exclusion Claimed (Millions)	Tax Impact of Exclusion* (Millions)
Less than $10,000	90.8	$513.0	$0.3
$10,000 to $19,999	141.9	$714.9	$3.9
$20,000 to $49,999	277.5	$1385.1	$25.5
$50,000 to $99,999	204.5	$971.7	$49.0
$100,000 to $199,999	128.4	$660.6	$56.1
More than $199,999	57.0	$335.1	$32.1
Total	900.0	$4,580.6	$166.9

Source: 2019 PIT Sample and Microsimulation Model
Detail may not add to total due to rounding.
*Includes part-year residents and nonresidents.

Discussion:

The goal of this program is to reduce the taxes paid by taxpayers who have lost their job and have received unemployment benefits. Paying taxes on such benefits creates an additional financial burden for the unemployed at a time when they are already suffering financially, as a result of a reduction in income.

The exclusion of unemployment benefits from AGI has a negative impact on horizontal equity. Consider two families, both receiving $40,000 this year. One family earns $40,000 in wages. The other family has one employed spouse who earns $30,000 and another who is unemployed and receives unemployment compensation of $10,000 per year. With California's current treatment of unemployment benefits, the first family will pay tax on the full amount of $40,000 of wages while the other family will only pay tax on the $30,000 of earned income. Another concern is that this program may create a disincentive for certain unemployed persons to seek jobs, since it reduces the after-tax cost of their unemployment. On the other hand, increasing the value of unemployment benefits may enable people to take the time necessary to find a better job fit for their next employment. These incentives may be more relevant for unemployed spouses of moderate-to-high-income taxpayers, since their need for employment may not be as urgent as compared that of lower-income individuals.

A macroeconomic benefit of this exemption is that it acts as a built-in stabilizer for the economy during times of high unemployment. As unemployment increases and the share of personal income made up by unemployment compensation increases, the effective tax rate on personal income will fall. The expenditure of these benefits by their recipients will tend to encourage economic growth.

It is not clear why privately-provided and government-provided unemployment compensation should receive different tax treatment.

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