CHAPTER 2B

PERSONAL INCOME TAX

HIGHLIGHTS

• Tax Rates	1% - 9.3%; brackets are indexed annually for inflation.
• Number of Filers	Over 15 million returns filed in 2004 (most recent year for which this information is available).
• Threshold of Taxation* (Adjusted gross income)	$10,764 for single taxpayers.* $21,527 for married taxpayers with no dependents.*
• Revenue**	2004-05 $42.7 billion 2005-06 (estimate) $45.5 billion 2006-07 (estimate) $48.7 billion 42.8% of total General Fund revenues. (2004-2005)
• Administration	Franchise Tax Board (FTB)

*For the 2005 tax year, taxpayers taking standard deduction and not claiming the renters' credit.

**From the Governor's 2006-07 Budget Summary

Source: FTB

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1. WHO PAYS THE PERSONAL INCOME TAX

Individuals who are residents of California are liable for the personal income tax on income derived from all sources. Nonresidents of this state must pay income tax on income derived from sources within California. However, nonresidents are generally allowed a credit against their California tax for taxes they pay to their state of residence on the same income.

In addition to individuals, partnerships, limited liability companies, estates, and trusts are taxed under the "Personal Income Tax Law".

PERSONAL INCOME TAX COMPONENTS

Federal Income From All Sources
Minus **Exempt Income (examples)**: Nontaxable Social Security and Railroad Retirement; Insurance Proceeds; Bequests and Gifts; Public Assistance; IRA and Keogh Interest; Interest on Certain State and Municipal Government Obligations; Scholarships and Fellowships
Equals **Total Gross Income**: Salaries and Wages; Taxable Interest; Dividends; Taxable State and Local Income Tax Refunds; Alimony Received; Business Income or Loss; Capital Gain or Loss; Taxable IRA Distributions; Taxable Pensions and Annuities; Rents and Royalties; Partnership Income or Loss; Estate and Trust Distributions: S Corporation Distributions; Farm Income; Unemployment Compensation; Taxable Social Security Benefits; Other Income; Lottery Winnings
Minus **Adjustments to Income**: IRA Contributions; One-Half of Self-Employment Tax; Self-Employed Health Insurance Deduction: Retirement Plan Deductions; Penalty on Early Withdrawal of Savings; Alimony Paid; Moving Expense; Student Loan Interest Deductions; MSA Deductions; HSA Deductions; Deduction for K-12 Educator Expenses; Deduction for Higher Education Expenses; Domestic Production Activities Deduction; Business Expenses of Reservists; Performing Artists; Certain Officials
Equals **Federal Adjusted Gross Income** (AGI) and Federal/State Differences
Minus **Federal Income Exempt From State Tax**: State Income Tax Refund: Unemployment Compensation; Taxable Social Security Benefits; Nontaxable Federal Interest and Dividend Income; Railroad Retirement and Sick-Pay; California Lottery Winnings; Fringe Benefits Difference; Earnings and Per Capita Payments of American Indian Tribal Members Living in Indian Country Affiliated with their Tribe; Differences in Clergy Housing Allowance; IRA Distributions - Basis Recovery of IRAs, Pensions and Annuities; Differences in Passive Activities; Differences in Depreciation and Amortization; Differences in Small Business Expensing Deduction; Differences in Student Loan Interest Deduction; Differences in Capital Gain or Loss; Differences in Other Gain or Loss; Differences in Net Operating Losses
Plus **State Income Exempt From Federal Tax and Federal/State Differences**: Interest on State or Municipal Bonds From Other States; Fringe Benefits Difference; Differences in Passive Activities; Differences in Depreciation and Amortization; Differences in Small Business Expensing Deduction; Differences in Student Loan Interest Deduction; HSA Deductions; Income Exempted by U.S. Treaty; Differences in Clergy Housing Allowance; Deduction for K-12 Educator Expenses; Deduction for Qualified Higher Education Expenses; Differences in Capital Gain or Loss; Differences in Other Gain or Loss; Differences in Net Operating Losses; Domestic Production Activities Deduction; Differences in Business Expenses of Performing Artists; Certain Officials
Equals **California Adjusted Gross Income** (AGI)
Minus **Deductions**: California Standard Deduction or Federal Itemized Deductions: Adjusted for Differences; State, Local and Foreign Income Taxes; Interest Paid; Contributions; Casualty and Theft Loss; Employee Business Expense; Miscellaneous Deductions
Equals **California Taxable Income**
Multiplied by **Applicable Marginal Tax Rates**
Minus **Tax Credits** (Credits are allowable only after applicable limitations based on the tentative minimum tax); Personal; Dependent; Blind; Senior: Senior Head of Household; Dependent Parent; Child Adoption; Child and Dependent Care Expenses; Prison Inmate Labor; Enterprise Zone Employee; Joint Custody Head of Household; Low-Income Housing; Enterprise Zone Hiring and Sales Tax; Research; Other States Taxes; Employer Child Care Program and Contribution: Prior year Alternative Minimum Tax; Local Area Military Base Recovery Area; Manufacturing Enhancement Area; Targeted Tax Area; Natural Heritage Preservation; Environmental Tax Credit; Nonrefundable Renters' Credit; Disabled Access for Small Business; Enhanced Oil Recovery; Solar Energy System; Farmworker Housing; Transportation of Donated Agricultural Products; Community Development Qualified Deposit; Rice Straw; Teacher Retention; Joint Strike Fighter; Miscellaneous Carryovers from Expired Credits
Plus **Other Taxes**: Alternative Minimum Tax; Tax on Early Use of IRA, Keogh or Annuity Contract; Tax on Accumulation Distributions of Trusts; Lump-Sum Distribution; Recapture Taxes; Use Tax; Mental Health Services Tax
Equals **Total Tax Liability**
Minus **Prepayment and Payments**: Withholding; Estimated Tax; Extensions: Excess SDI; Overpayment Applied from Prior Year
Plus **Voluntary Contributions**
Equals **Overpayment or Balance Due**

Source: Franchise Tax Board

2. CALCULATION OF THE PERSONAL INCOME TAX

Taxpayers must compute their tax liability based on income earned during the year, usually the calendar year. Generally, taxpayers must add up all sources of nonexempt income and subtract the adjustments and deductions to which they are entitled to calculate "taxable income". They then apply the appropriate tax rate to their taxable income to arrive at a preliminary tax liability. After calculating their preliminary tax liability, taxpayers may then apply tax credits, which reduce liability (i.e., every $1 in tax credits reduces a taxpayer's tax liability by $1). In most cases, the tax liability remaining after tax credits are applied is the actual tax liability. However, a few taxpayers are liable for additional taxes under special circumstances.

The chart on the preceding page illustrates the steps involved in calculating final tax liability. As the chart shows, the income that is actually subject to tax is much smaller than a taxpayer's total income earned or received.

3. RELATIONSHIP OF STATE AND FEDERAL TAX FORMS

California's tax law is increasingly similar to federal income tax law. This allows substantial simplicity for state tax forms. Today, a majority of the steps in computing income subject to tax are done on federal Forms 1040, 1040A, or 1040EZ. California Forms 540 and 540A start with federal adjusted gross income (AGI). These forms then require taxpayers to make adjustments to reflect differences in state law, apply state tax credits, and compute state tax.

A third state form, without a comparable federal form, offers taxpayers a different, simplified method of calculating their taxes. Beginning with the 1999 tax year, Form 540 2EZ ("too easy") replaced Form 540 EZ. Form 540 2EZ begins with the taxpayer's total wages. However, the tax tables that accompany Form 540 2EZ already include the standard deduction and personal and dependent exemption credits, thereby simplifying the calculation processes required for other state forms.

4. TAXABLE AND NONTAXABLE INCOME

For purposes of the personal income tax, income is measured or defined in four important stages: (a) Calculation of exempt income; (b) Gross income; (c) AGI; and (d) Taxable income (TI).

The major sources of income that are taken into account in computing tax liability include the following:

° Gross Income. Gross income is the starting point for calculating tax on the federal return. Gross income includes income from all sources, unless otherwise exempt. Income that must be included in gross income for both state and federal purposes includes salaries, wages, commissions, tips, alimony received, dividends, interest earnings, annuities, pensions, net gains from the sale of capital assets, net partnership and proprietorship income, net farm income, and others. Losses from capital assets, partnerships, proprietorships may be limited.

For some items, the amount of income entered on the tax return may be a negative number if the taxpayer has incurred a loss.

- Exempt Income. Certain types of income are exempt from tax. In many cases, taxpayers are not required to report this income on their tax return. Some of these items are exempt in California but are taxable for federal purposes. The most common income items that are taxable on the federal return and exempt on the state return are California lottery winnings, a portion of Social Security and Railroad Retirement benefits, unemployment compensation, and interest from U.S. Savings Bonds and Treasury Bills. Since California uses federal income as the starting figure, these items must be subtracted from federal income before calculating California tax.

- Adjusted Gross Income. After totaling all items included in gross income, certain deductions are allowed to compute AGI. These "adjustments" include payments into certain retirement plans (IRAs, Keogh plans, self-employed plans, etc.), alimony paid, penalties paid on early withdrawal of savings, and the employer portion of Social Security that is paid by the self-employed (i.e., the self-employment tax). The remaining amount is AGI.

- Taxable Income. Either the standard deduction or itemized deductions may further reduce AGI. These are described below. The remaining amount is taxable income. Tax rates are applied to this amount in order to compute tax owed before credits.

5. DEDUCTIONS FROM ADJUSTED GROSS INCOME (AGI)

All taxpayers are allowed to deduct certain amounts from AGI. Most deductions are intended to reduce the amount of income subject to tax to reflect certain living costs incurred by all taxpayers. The rationale behind deductions is that these living costs affect taxpayers' ability to pay.

The value of a deduction to a taxpayer (i.e., the amount by which the deduction reduces the taxpayer's tax liability) generally may be estimated by multiplying the deduction by the taxpayer's highest marginal tax rate (see Section 8 of this chapter for a discussion of marginal rates). For example, the approximate state tax savings to a person in the top tax bracket (9.3%) who deducts a $100 expense is $9.30 ($100 expense times the 9.3% tax rate).

A taxpayer may reduce his or her AGI by the larger of either the standard deduction or the total of his or her allowed itemized deductions.

Standard Deduction. The standard deduction is a fixed dollar amount intended to approximate deductible living expenses. In 2005, the standard deduction amounts under California law are as follows:

Single and Married Filing Separately	$3,254
Married Filing Jointly, Surviving Spouse, and Head of Household	$6,508

These amounts are indexed annually for inflation.

Standard deduction amounts in federal law are different from those in California law. In 2005, federal amounts are as follows:

Single	$5,000
Married Filing Jointly	$10,000
Head of Household	$7,300
Married Filing Separately	$5,000

Federal law also allows taxpayers to increase their standard deductions if they have dependents, are over age 65, and/or blind.

Unlike federal law, California does not allow larger standard deductions for taxpayers that have dependents and/or are over age 65 and/or blind. Instead, state law provides exemption credits (see Section 7).

Itemized Deductions. As an alternative to the standard deduction, both state and federal law allow various specific expenses (called itemized deductions) to be deducted from AGI. The major itemized deductions permitted include the following:

- Home mortgage interest on first and second homes, subject to certain limits;
- Property taxes;
- Charitable contributions up to an annual cap. Amounts above the cap may be carried over and deducted in subsequent years;
- Unreimbursed medical expenses in excess of 7.5% of AGI;
- Unreimbursed casualty and theft losses of over $100.00. However, only losses in excess of 10% of AGI may be deducted; and
- Certain miscellaneous expenses in excess of 2% of AGI. Examples of deductible miscellaneous expenses include union dues, uniforms, job-related educational expenses, tax return preparation fees, safe deposit box costs, and unreimbursed business expenses.

California's rules on itemized deductions are very similar to federal rules. The major difference is that federal law allows an itemized deduction for state income taxes paid, whereas California law does not.

Both state and federal law limit itemized deductions for high-income filers. For 2005, the California phase-out affects single filers with AGIs in excess of $143,839, joint filers with AGIs in excess of $287,682, and heads of household with AGIs in excess of $215,762. The 2005 federal phase-out affects single taxpayers, married taxpayers filing jointly, heads of household, and qualifying widowers with AGIs in excess of $145,950, and married taxpayers filing separately with AGIs in excess of $72,975.

Exemptions. In addition to allowing taxpayers a choice of claiming either the standard deduction or itemizing deductions, federal law also allows taxpayers to claim personal exemptions, which are phased out for higher-income taxpayers. The 2005 federal exemption amount equals $3,200. The 2005 phase-out amounts are $218,950 for married taxpayers filing jointly, $182,450 for heads of household, $145,950 for single taxpayers, and $109,475 for married taxpayers filing separately. These amounts are indexed annually for inflation.

Once a taxpayer has an AGI that exceeds the personal exemption phase-out amount, he or she must decrease the value of his or her exemption by a specified percentage for each $2,500 (or fraction thereof) by which the taxpayer's AGI exceeds the applicable threshold amount. The phase-out rate is 2% for single taxpayers, heads of household, and married taxpayers filing jointly, and 4% for a married taxpayer filing separately.

6. FILING STATUS

Taxpayers must file using one of five filing statuses: (a) Single; (b) Married Filing Separately; (c) Married Filing Jointly; (d) Head of Household; or (e) Surviving Spouse. Filing status affects tax liability because it determines which tax rate schedules and personal exemption credits a taxpayer may claim on his or her return.

A head of household is generally a person who is not married at the end of the taxable year and who has a child or other relative living with him or her for more than half the year.

A taxpayer qualifies to file as a surviving spouse if he or she is a widow(er) who remains unmarried and maintains a dependent in the home. The taxpayer may file as a surviving spouse for the two tax years following the tax year in which the taxpayer's spouse dies. In the year the spouse dies, the taxpayer must file a joint return. The surviving spouse filing status generally permits use of tax rates, deductions, and credits similar to those used by joint filers.

In general, California taxpayers must use the same filing status on their state returns as they use on their federal returns. In certain situations where one spouse is in the military or a nonresident, California permits a filing status different from filing status claimed on the taxpayer's federal return. A taxpayer might choose different filing statuses at the state and federal level if he or she could lower his or her tax liability by doing so.

7. PERSONAL, DEPENDENT, SENIOR, AND BLIND EXEMPTION CREDITS

California taxpayers are entitled to personal and dependent exemption credits in addition to their deductions. These exemption credits are intended to shelter a minimum amount of income of each person in the household from tax. The federal government offers similar tax relief through the personal exemption and increased standard deductions for certain qualifying individuals.

The personal exemption credit can be claimed by all taxpayers, except those who can be claimed as a dependent on another person's return. An example would be a college student who earns enough income to file his or her own tax return, but who is also eligible to be claimed as dependent on his or her parents' return.

A dependent exemption credit may be claimed for any relative of the taxpayer (child, stepchild, parent, stepparent, sibling, etc.) whom the taxpayer supports for over half of the calendar year. A non-relative who lives in the taxpayer's home and is supported by the taxpayer can also be claimed as a dependent.

An additional exemption credit can be claimed for any person in a household who is blind or age 65 or older on the last day of the taxable year. A person who is both blind and a senior is eligible for two additional exemption credits in addition to the personal or dependent exemption credit.

The 2005 personal, dependent, senior and blind exemption credits are as follows:

Single, Head of Household and Married Filing Separately	$ 87
Married Filing Jointly and Surviving Spouse	$174
Each Dependent	$272
Additional Credit for Person Over Age 65	$ 87
Additional Credit for Blind Person	$ 87

These credits are indexed for inflation annually.

State exemption credits are phased out for taxpayers with federal AGIs that exceed a threshold amount. The threshold amounts for 2005 are $287,682 (married filing jointly and surviving spouse), $215,762 (head of household), and $143,839 (single and married filing separately). Like the exemption credits, the phase-out threshold amounts are indexed for inflation annually.

Once a taxpayer reaches the phase-out threshold, he or she is required to reduce his or her credits by $6 (if a single taxpayer, head of household, or married filing separately) or $12 (if married filing jointly or surviving spouse) for each $2,500 ($1,250 if married filing separate) by which

that taxpayer's AGI exceeds the threshold amount. For example, a married couple with two dependents would have their total exemption credits reduced by $24 (12 + 6 + 6) for each $2,500 by which their AGI exceeded the threshold amount.

8. TAX RATES AND BRACKETS

Proposition 63, approved by the voters in November 2004, adds a 1% surtax on that portion of a taxpayer's taxable income in excess of $1 million, effective with tax years beginning on January 1, 2005. This tax surcharge is expected to raise approximately $275 million in 2004-05, $750 million in 2005-06, $800 million in 2006-07, and increasing amounts thereafter. Approximately 25,000 to 30,000 taxpayers are expected to be liable for the surcharge.

Revenue generated by the Proposition 63 tax surcharge will be used to expand existing county mental health programs and create new programs.

California law provides for six progressive marginal tax rates applied to taxable income: 1%, 2%, 4%, 6%, 8%, and 9.3%. The term "marginal tax rate" refers to the rate applied to the last (or highest) dollar of taxable income. For tax years beginning on or after January 1, 2005, a 1% surtax will be imposed on taxable income in excess of $1 million.

Under a system of progressive marginal tax rates (or "brackets"), each additional increment of income a person earns is subject to a higher tax rate. Thus, for example, the first increment of income is taxed at a rate of 1%, the second (next greater) increment is taxed at a rate of 2%, the third increment is taxed at a rate of 4%, and so on. The principle behind progressive marginal tax rates is that people with more income have a greater ability to pay taxes than those with lower incomes.

The California tax rates and income brackets that apply for the 2005 year are shown in Table 2 on the next page. Note that each filing status has the same rates of tax but the amounts of income included in each respective bracket are different. Table 2 shows that in 2005, the maximum tax rate of 9.3% applied to single taxpayers with taxable incomes of $41.476 or more and to married taxpayers with taxable incomes of $82,952 or more. The income brackets are indexed annually for inflation (see Section 10 of this chapter).

TABLE 2

CALIFORNIA TAX RATES FOR 2005

IF TAXABLE INCOME IS:

Over:	But Not Over:	The Tax Amount is:
Single Person or Married Filing Separate – Schedule X		
$ 0	$ 6,319	1% of the amount over $0
$ 6,619	$ 14,571	$63.19 plus 2% of the amount over $6,319
$ 14,979	$ 22,997	$235.39 plus 4% of the amount over $14,979
$ 23,641	$ 31,925	$582.87 plus 6% of the amount over $23,641
$ 32,819	$ 40,346	$1,133.55 plus 8% of the amount over $32,819
$ 41,476	$999,999	$1,826.11 plus 9.3% of the amount over $41,476
$999,999	No Limit	$90,968.75 plus 10.3% of the amount over $999,999
Married Filing Joint of Qualifying Widow(er) with Dependent Child – Schedule Y		
$ 0	$ 12,638	$118.18 plus 1% over $0
$ 12,638	$ 29,958	$126.38 plus 2% of the amount over $12,638
$ 29,958	$ 47,282	$472.78 plus 4% of the amount over $29,958
$ 47,282	$ 65,638	$1,165.74 plus 6% of the amount over $47,282
$ 65,638	$ 82,952	$2,267.10 plus 8% of the amount over $65,638
$ 82,952	$999,999	$3,652.22 plus 9.3% of the amount over $82,952
$999,999	No Limit	$88,937.59 plus 10.3% of the amount over $999,999
Head of Household – Schedule Z		
$ 0	$ 12,644	1% of the amount over $0
$ 12,644	$ 29,959	$126.44 plus 2% of the amount over $12,644
$ 29,959	$ 38,619	$472.74 plus 4% of the amount over $29,959
$ 38,619	$ 47,796	$819.14 plus 6% of the amount over $38,619
$ 47,796	$ 56,456	$1,369.76 plus 8% of the amount over $47.796
$ 56,456	$999,999	$2,062.56 plus 9.3% of the amount over $56,456
$999,999	No Limit	$89,812.06 plus 10.3% of the amount over $999,999

TABLE 3

FEDERAL TAX RATES FOR 2005

IF TAXABLE INCOME IS:

Over:	But Not Over:	The Tax Amount is:
Single Person - Schedule X:		
$ 0	$ 7,300	10% of the amount over $0
$ 7,300	$ 29,700	$730 plus 15% of the amount over $7,300
$ 29,700	$ 71,950	$4,090 plus 25% of the amount over $29,700
$ 71,950	$150,150	$14,652.50 plus 28% of the amount over $71,950
$150,150	$326,450	$36,548.50 plus 33% of the amount over $150,150
$326,450	No Limit	$94,727.50 plus 35% of the amount over $326,450
Married Filing Joint or Qualifying Widow(er) - Schedule Y-1:		
$ 0	$ 14,600	10% of the amount over $0
$ 14,600	$ 59,400	$1,460 plus 15% of the amount over $14,600
$ 59,400	$119,950	$8,180 plus 25% of the amount over $59,400
$119,950	$182,800	$23,317.50 plus 28% of the amount over $119,950
$182,800	$326,450	$40,915.50 plus 33% of the amount over $182,800
$326,450	No Limit	$88,320 plus 35% of the amount over $326,450
Married Filing Separately - Schedule Y-2:		
$ 0	$ 7,300	10% of the amount over $0
$ 7,300	$ 29,700	$730 plus 15% of the amount over $7,300
$ 29,700	$ 59,975	$4,090 plus 25% of the amount over $29,700
$ 59,975	$ 91,400	$11,658.75 plus 28% of the amount over $59,975
$ 91,400	$163,225	$20,457.75 plus 33% of the amount over $91,400
$163,225	No Limit	$44,160 plus 35% of the amount over $163,225
Head of Household - Schedule Z:		
$ 0	$ 10,450	10% of the amount over $0
$ 10,450	$ 39,800	$1,045 plus 15% of the amount over $10,450
$ 39,800	$102,800	$5,447.50 plus 25% of the amount over $39,800
$102,800	$166,450	$21,197.50 plus 28% of the amount over $102,800
$166,450	$326,450	$39,019.50 plus 33% of the amount over $166,450
$326,450	No Limit	$91,819.50 plus 35% of the amount over $325,450

9. INDEXING

Many components of the Personal Income Tax Law used to calculate tax liability are modified annually to adjust for inflation using a method called indexing. For example, income brackets, exemption credits, the standard deduction, the joint custody head of household credit, and many of the phase-out limits in the Personal Income Tax Law are indexed annually. Indexing is intended to prevent taxpayers from being pushed into higher marginal tax brackets by increases in income that just keep pace with inflation, while the taxpayers' real buying power is not increasing.

The indexing adjustment equals the percentage difference between the California Consumer Price Index (CCPI) in June of the current year and June of the prior year. Each dollar value to be indexed is multiplied annually by this percentage change.

Indexing is illustrated below using one of the most important components of the personal income tax – brackets. As noted above, annual indexing of income within the tax brackets is intended to keep a taxpayer in the same bracket, as long as his or her income increases no faster than the CCPI. For example, the effect of indexing on two hypothetical taxpayers would be as follows:

- A taxpayer who gets a cost-of-living wage increase exactly equal to inflation will have more income in dollars but will have the same buying power as is in the previous year. Without indexing, the taxpayer's increased income might bump him or her into a higher marginal tax bracket, causing the taxpayer to owe additional income tax reflecting an higher tax rate as well as increased income. Indexing keeps the taxpayer's tax rate at the same level as the prior year, since the taxpayer's buying power remains the same.

- A taxpayer on a fixed income loses buying power in inflationary times. Without indexing, the taxpayer's tax liability would remain the same, even though the taxpayer's income was worth less in each succeeding year.

  Indexing of the tax rate brackets lowers the taxpayer's tax liability, consistent with the taxpayer's decline in buying power.

Federal law began indexing tax rate brackets in 1985 and the standard deduction in 1989. The federal indexing measure differs from California through use of the U.S. Consumer Price Index and a different 12-month period (August to August).

10. TAX CREDITS

Tax credits reduce tax liability on a dollar-for-dollar basis (i.e., $1 in tax credits reduces a taxpayer's tax liability by $1). After the taxpayer computes tax due for his or her taxable income, he or she subtracts the credits to which he or she is entitled, thereby reducing the amount of tax due. Thus, credits have a greater impact than deductions, whose value in

reducing tax liability (as discussed in Section 5 of this chapter) equals the amount of the deduction times the tax rate. State tax credits are not refundable if they exceed total tax due. However, in some cases credits that exceed tax liability may be carried forward and claimed against a taxpayer's future years' taxes.

Credits are usually provided to give tax relief to people who incur certain nondiscretionary costs, have limited ability to pay taxes, or to provide incentives to people to engage in certain activities that are socially or economically desirable. Tax reform legislation enacted in 1987 placed sunset dates (i.e., automatic repeal) on many credits in the Personal Income Tax Law in order to give the Legislature an opportunity to evaluate their impact.

The amount of the tax credits allowable in any taxable year may be limited by the taxpayer's alternative minimum tax liability or by tentative minimum tax (see Section 14 of this chapter for further information).

Some of the tax credits allowed in state law are similar to credits offered in federal law. However, in most cases the federal credits are larger.

The major credits allowed in state law are described below. The credits are available to both full-time and part-time California residents, as well as to nonresidents with California-source income. California residents are entitled to the full value of each credit, as long as they meet all of the eligibility criteria for the credits. Nonresidents and part-year residents are required to prorate the amount of each credit claimed using rules specified in statute.

Renters' Credit. The Legislature enacted a "renters' credit" in 1972. In the first 20 years following its inception, both the value of the credit and the income eligibility rules applied to taxpayers that claimed the credit varied, but the credit was always available. However, the renters' tax credit was suspended when California experienced severe economic pressures in the early 1990s. As part of budget agreements, the credit was not available during the five-year period corresponding to the 1993 through 1997 income years. The Legislature reinstated the renters' credit effective January 1, 1998.

Historically, the renters' tax credit was also refundable. However, as reinstated, the renters' credit is nonrefundable and is subject to income phase-outs. For 2005, married taxpayers filing jointly, heads of household, and surviving spouses with AGIs of $61,588 or less may claim a credit of $120. Single taxpayers and married taxpayers filing separately with AGIs of $30,794 or less may claim a credit of $60. See Chapter 6F (Renters' Credit) for more information.

There is no similar credit in federal law.

Senior Head of Household Credit. Taxpayers who are 65 years of age or older on December 31st of the current tax year, qualified as head of household during either the

previous two tax years by providing a household for a qualifying individual who died during one of the previous two tax years, and whose AGI for 2005 is $56,262 or less, may claim a credit equal to 2% of taxable income. In 2005, the maximum allowable credit is $1,060. The AGI cap and maximum allowable credit are indexed annually for inflation.

There is no similar credit in federal law.

Joint Custody Head of Household Credit. Taxpayers who qualify as joint custody heads of household may claim a state tax credit that offsets a portion of their tax liability. To qualify, the taxpayer must: (a) be unmarried at the end of the year; (b) have custody of a dependent under a custody agreement for between 146 and 219 days of the year; and (c) furnish over half of all household expenses. The credit is 30% of the net tax, not to exceed $346 for the 2005 tax year. The maximum available credit is indexed for inflation annually. The purpose of this credit is to allow divorced couples who share custody of a child to share the benefits of the head of household filing status. A similar credit is available to separated married persons who support a dependent parent.

There is no similar credit in federal law.

Credit for Taxes Paid to Other States. In order to avoid double taxation, California residents are generally allowed a credit for income taxes paid to another state on income that is also taxed by California. The credit may not exceed the tax California would have imposed on the income taxed by such other state. If the other state taxes this income at a lower rate than California, this credit has the effect of allowing California to tax only a portion of the income taxed by the other state.

Excess Employee's State Disability Insurance (SDI) Credit. Employees who work for more than one employer and who earned over $79,418 during the 2005 tax year may have paid more than the maximum State Disability Insurance through overwithholding. The excess may be recovered by claiming a credit against the California personal income tax on a Form 540 or 540A tax return.

Child Adoption Cost Credit. This credit is equal to 50% of the costs of adopting a minor child who is a citizen or legal resident of the United States and is in the custody of a California public agency or a political subdivision of California. The credit can be claimed in the taxable year in which the decree or order of adoption is entered, even though qualifying costs paid or incurred in prior years may qualify for the credit. Costs eligible for the credit include: (a) fees for required services of either the Department of Social Services or a licensed adoption agency; (b) travel and related expenses for the adoptive family that are directly related to the adoption process; and (c) medical fees and expenses that are not reimbursed by insurance and are directly related to the adoption process. The maximum allowable credit cannot exceed $2,500 per minor child. This credit may be carried over and is allowed for taxable years beginning on or after January 1, 1994.

Federal tax law also offers a child adoption cost credit. Taxpayers may claim a credit of up to $10,630 for the qualified adoption expenses of each eligible child. Phase-out of the federal credit begins for taxpayers with modified AGIs of more than $159,450; the federal credit is completely phased out for taxpayers with modified AGIs of $199,450 or more for the 2005 tax year. The limitation on eligible expenses and phase-out incomes are increased for inflation annually. Qualified adoption expenses include reasonable and necessary adoption fees, court costs, attorney fees, and other expenses directly related to the legal adoption of an eligible child. The federal credit may be carried over for up to five years.

Child and Dependent Care Credit. Beginning with the 2000 taxable year, taxpayers that maintain a household within the state for a qualifying individual may claim a refundable child and dependent care credit for employment-related expenses. The state credit supplements a similar federal household and dependent care credit.

As defined by the federal law, a qualifying individual is a dependent of the taxpayer that is under the age of 13 or a dependent or spouse who is physically or mentally unable to care for himself or herself. Employment-related expenses are defined as those incurred to enable the taxpayer to obtain or retain gainful employment.

The federal credit, which can be applied to a maximum of $3,000 in expenses for one dependent and $6,000 in expenses for two or more dependents, is equal to between 20% and 35%, depending on a taxpayer's AGI. Taxpayers with AGIs of $15,000 or less are eligible for the 35% credit. The amount of the credit decreases by one percentage point for each $2,000 by which a taxpayer's AGI exceeds $15,000. Thus, a credit of 20% may be claimed by taxpayers with AGIs over $43,000.

The state credit amount is a percentage of the federal credit, as follows:

California AGI	Credit Percentage (% of Federal Credit)
$40,000 or less	50%
$40,001 to $70,000	43%
$70,001 to $100,000	34%
Over $100,000	0%

California taxpayers may claim the state credit regardless of whether they have federal tax liability.

Teacher Retention Tax Credit [Suspended in the 2004 and 2005 taxable years for cost-saving reasons, SB 1100 (Committee on Budget and Fiscal Review, Chapter 226, Statutes of 2004]. In 2001, California began offering a nonrefundable credit to credentialed public school teachers based on their years of teaching experience. The credit schedule is as follows:

Years of Experience As Of the Last Day Of The Taxable Year	Credit
4 or 5	$ 250
6 to 10	$ 500
11 to 19	$1,000
20 or more	$1,500

In order to be eligible for the credit, a teacher must hold either a preliminary or professional clear credential as determined by the Commission on Teacher Credentialing and must work in a public elementary, secondary, or vocational-technical school. The maximum amount of the credit that may be claimed by any qualified teacher is capped at 50% of the amount of tax attributable to his or her service as a teacher. Tax attributable to service as a teacher is computed as the percentage of the taxpayer's total tax that represents the ratio of wages and salary from teaching services (but excluding pensions or other deferred compensation) to total AGI from all sources. No unused portion of the teacher retention tax credit may be carried forward for use in subsequent years.

Credits for Businesses. A number of other credits are available for business taxpayers that file under the personal income tax, such as sole proprietorships and partnerships. Refer to the Bank and Corporation Tax chapter (Chapter 2C) for a description of tax credits applicable to businesses.

Long-term care credit. For taxable years beginning in 2000 and ending in 2004, the state offers a $500 credit to each taxpayer whose adjusted gross income is less than $100,000 and for whom the taxpayer is an eligible caregiver for the taxable year. An eligible caregiver is either the taxpayer, his or her spouse, or his or her dependent. Anyone for whom the credit may be claimed must also be physician-certified as requiring long-term care for at least 180 consecutive days, at least one of which occurs during the taxable year. In order to be certified as requiring long-term care, an individual must meet certain age-specific criteria provided in law.

In order to claim the credit, a taxpayer must include on his or her personal income tax return the name and taxpayer identification number of the individual for whom care is being provided and the identification number of the physician certifying that the individual requires long-term care. When more than one person is an eligible caregiver for the same individual, only one caregiver may claim the credit.

11. CAPITAL GAINS AND LOSSES

Capital gains are profits from the sale of property and other capital assets. They are classified as a different type of income from "ordinary income," which includes wages, salaries, and interest.

Capital assets are defined as all property except the following: inventories; property held for sale in the ordinary course of business; depreciable business property; and real property used in business. Capital assets include real property (land and buildings), personal property, and intangible assets (such as stock).

Capital gains are measured as the difference between the amount realized when the asset is sold and the asset's basis. Although an asset's basis is normally that asset's original purchase price, basis can be adjusted to reflect improvements and costs of sale. Any amounts invested in improvements are added to the purchase price to increase basis; costs of sale are deducted from the sales price to reduce basis. Capital gains are generally recognized in the year an asset is sold or otherwise disposed.

Through 1986, capital gains were accorded special tax treatment in California. During that time, gains on assets held longer than one year were partially excluded from tax. However, beginning in 1987, California began including all capital gains within the measure of a taxpayer's income. California's tax treatment of capital gains is different from federal treatment, because California applies the same tax rates to capital gains as applies to ordinary income; the federal government applies lower rates to qualifying capital gains.

Under federal (but not state) law, most types of investments held more than one year are subject to capital gains tax at a top rate of 20% (10% for investors in the 15% tax bracket) if the sale takes place before May 6, 2003.

However, individuals in the 15% tax bracket will pay capital gains tax at a rate of 8%, instead of 10%, on profits from the sale before May 6, 2003 of investments held more than five years.

For sales on or after May 6, 2003, and before January 1, 2009, the maximum capital gain rate is 15% (5% for individuals taxed in the 10% or 15% tax bracket). For sales in 2009 and later, the rates return to those that applied to sales before May 6, 2003.

These lower rates apply to most (but not all) types of investments. Among those ineligible are collectibles with a maximum rate of 28%. Nor do the lower rates apply to gains from the sale of investment real estate to the extent of depreciation deductions previously claimed with a maximum rate of 25%.

Special enacted state and federal laws provide an exemption for 50% of the capital gains realized from the sale of qualified small business stock. Qualifying stock must be issued after August 10, 1993 and be held for a least five years prior to sale. For state tax purposes, the company in which the investment is made must be located in California and have assets of not more than $50 million. Certain industry and other limitations apply, including industry growth in payroll, etc.

As under federal law, capital losses are fully deductible against capital gains realized in the same year. In addition, up to $3,000 of capital losses in excess of capital gains are deductible against ordinary income in any taxable year. If excess capital losses are greater than $3,000, the unused portion may be carried forward indefinitely to offset capital gains in future years and to deduct against ordinary income subject to the $3,000 annual limit. Federal law allows a three-year carryback of capital losses, but California does not.

State law also conforms to federal capital gains treatment on sale or exchange of a principal residence. Specifically, state and federal laws provide that a single taxpayer may exclude up to $250,000 and a married taxpayer filing jointly may exclude up to $500,000 of gain realized on the sale or exchange of a principal residence. The exclusion is allowed each time a taxpayer selling a principal residence meets certain eligibility requirements, but generally no more frequently than once every two years. To be eligible for the exclusion, a taxpayer must have owned the residence and occupied it as a principal residence for at least two of the five years prior to the sale or exchange. Federal and state laws repealed the once-in-a-lifetime exclusion of $125,000 and the rollover of gain from the sale of a principal residence provisions that previously existed.

See Chapter 6D for a further discussion of special homeowner provisions.

12. DEPRECIATION AND AMORTIZATION

Depreciation and amortization deductions allow taxpayers to recover capital investments in certain assets over the useful lives of those assets by deducting reasonable allowances for the exhaustion, wear, and tear of property.

Depreciation and amortization are allowed for property used in a trade or business or for the production of income (investment). Depreciable property includes most kinds of tangible property and improvements to real property, farm buildings, machinery, and other physical assets. Intangible assets that may be amortized include copyrights, licenses, franchises, goodwill, and covenants not to compete. Depreciation and amortization are not allowed for property used for personal purposes, inventory and stock in trade, land, and depletable natural resources.

Under the personal income tax law, California generally conforms to the federal depreciation system for assets placed in service on and after January 1, 1987. This is called the Modified Accelerated Cost Recovery System (MACRS). Under MACRS, all depreciable assets are placed in classes. These class assignments determine the assets' useful lives (i.e., the periods over which the assets may be depreciated) and the method of depreciation that must be used. The amount to be depreciated is the property's basis or its acquisition price. In general, MACRS allows shorter useful lives and more accelerated depreciation methods than are allowed under other permissible depreciation systems, thereby allowing larger depreciation deductions.

Under federal (but not state) law, a taxpayer is allowed to elect to take a bonus first-year depreciation deduction equal to 30% of the adjusted basis of qualified property (including New York Liberty Zone property) placed in service by the taxpayer after September 10, 2001. That percentage increases to 50% for property placed in service after May 5, 2003, and before January 1, 2005. The additional first year depreciation deduction generally is determined without any proration based on the length of the taxable year in which the qualified property or New York Liberty Zone property is placed in service. The adjusted basis of this property generally is its cost or other basis multiplied by the percentage of business/investment use, reduced by the amount of any Section 179 expense deduction and adjusted to the extent provided by other provisions of the Internal Revenue Code. The remaining adjusted basis of this property is depreciated using the applicable depreciation provisions under the Code for the property. This depreciation deduction for the remaining adjusted basis of the qualified property or New York Liberty Zone property for which the additional first year depreciation is deductible is allowed for both regular tax and alternative minimum tax purposes.

In addition, in lieu of depreciation, existing federal and state laws (Internal Revenue Code Section 179) allow a deduction to taxpayers with a sufficiently small amount of capital expenditures for depreciable property. These taxpayers may elect to expense (i.e., to deduct immediately rather than depreciate over time) the cost of qualified property placed in service for the taxable year and purchased for use in the active conduct of a trade or business. Federal and state limits differ. The limit is $105,000 in 2004 under federal law but remains $25,000 for California. However, starting in 2005, California "C" Corporations are allowed to elect, in lieu of a maximum of $2,000 additional first-year depreciation, a Section 179 deduction of up to a maximum of $25,000. The allowed deduction is reduced (but not below zero) by the amount by which the cost of qualifying property placed in service during the taxable year exceeds $400,000 under federal law and $200,000 for California.

California permits accelerated write-off for acquisitions of personal property for exclusive use within identified incentive zones. Taxpayers doing business in certain areas such as Enterprise Zones (EZs), Local Agency Military Base Recovery Areas (LAMBRAs), and Targeted Tax Areas (TTAs) may elect to treat 40% of the cost of qualified property purchased for exclusive use within the area as a deduction in the year the property is placed in service. The maximum cost taken into account in any taxable year depends upon the length of time the area has been designated as a qualifying zone or area, but may not exceed $100,000.

The MACRS system is not permitted under the California bank and corporation tax law. However, California law permits S Corporations to compute depreciation under the rules contained in the Personal Income Tax Law. For that reason, S Corporations can use both MACRS and the Section 179 deductions referenced above. Refer to the Bank and Corporation Tax chapter of this Reference Book (Chapter 2C) for a description of depreciation deductions allowed for other corporate taxpayers.

13. CARRYOVER OF NET OPERATING LOSSES

Net operating losses (NOLs) occur in the course of a trade or business when deductions exceed income. Under federal law, a net operating loss can be carried back for two years (five years for losses arising in 2001 and 2002) and carried forward for 20 years. California does not normally allow NOL deductions to be carried back. For taxable years beginning before January 1, 2000, California allowed 50% of NOLs to be carried forward for five years. Beginning with the 2000 tax year, the carryforward periods and carryforward amounts were increased as follows:

Tax Year	Allowed Carryforward	Length of Carryforward
1999 and earlier	50%	5 years
2000, 2001	55%	10 years
2002, 2003	60%	10 years
2004 and after	100%	10 years

In 2002, as part of the budget package, California suspended taxpayers' abilities to claim NOL deductions during the 2002 and 2003 tax years. However, taxpayers were given two additional years in which to claim NOLs accrued prior to January 1, 2002 and one additional year in which to claim NOLs accrued during the 2002 taxable year.

Prior to the changes made in 2002, special NOL carryforward rules were available to specific groups of taxpayers, including new businesses, small businesses, businesses located in EZs, LAMBRAs, and TTAs, and taxpayers involved in bankruptcies and certain bankruptcy reorganizations. Starting in 2004, virtually all businesses are treated the same way under California's NOL laws. Specific details regarding these provisions are described in Section 8 of Chapter 2C.

14. ALTERNATIVE MINIMUM TAX

Noncorporate taxpayers who take advantage of certain tax preferences must calculate and pay an alternative minimum tax (AMT) at a 7% rate if their tentative minimum tax (TMT) exceeds their regular tax due. The purpose of the AMT is to ensure that taxpayers who take advantage of special tax reduction provisions such as deductions and credits pay at least some minimum amount of tax on their preferentially treated income. California's AMT rules are patterned after federal law, which imposes the AMT at a graduated rate of 26% on the first $175,000 of taxable income above the exemption amount and 28% of the amount exceeding $175,000 above the exemption amount. California's AMT replaced the add-on preference tax, which was a part of California's personal income tax law until 1987.

California taxpayers that believe they may be subject to AMT must perform the following steps to determine whether they owe any tax in addition to their regular tax liability:

- Calculate regular tax liability;

- Calculate alternative minimum taxable income (AMTI) in excess of the exemption amount. Although the AMTI calculation is extremely complex, it generally requires taxpayers to forego their deductions and credits and instead allows them to subtract only a fixed-dollar AMT exemption amount;

- Multiply AMTI by the AMT rate of 7% to calculate TMT; and

- Compare TMT to regular tax liability. If TMT exceeds regular tax, the difference equals the taxpayer's AMT and must be added to the regular tax and paid by the taxpayer.

For 2005, the exemption amounts are $70,531 for married persons filing jointly; $52,898 for single and head of household filers; and $35,263 for married persons filing separately. These exemption amounts phase out to zero if alternative minimum taxable income exceeds $264,488 for married taxpayers filing jointly; $198,366 for single and head of household filers, and $132,243 for married taxpayers filing separately. The exemption and phase-out amounts are indexed annually for inflation.

AMT has an important interaction with tax credits. Most credits can reduce regular tax down to, but not below TMT. However, certain specific credits are not subject to this limitation. These specific credits are:

- Enterprise Zone hiring credit;
- Enterprise Zone sales or use tax credit;
- Program Area hiring credit carryover;
- Program Area sales and use tax credit carryover;
- Los Angeles Revitalization Zone (LARZ) construction hiring credit carryover;
- LARZ hiring credit carryover;
- LARZ sales and use tax credit carryover;
- Targeted Tax Area sales or use tax credit;
- Targeted Tax Area hiring credit;
- Solar energy credit carryover;
- Commercial solar energy credit carryover;
- Commercial solar electric system credit carryover;
- Research and development credit;
- Orphan drug credit carryover;
- Low-income housing credit;
- Adoption cost credit;
- Other state tax credit;
- Renters' credit;
- Manufacturer's investment credit carryover;

- Teacher retention tax credit;
- Credit for refund of excess unemployment compensation contributions; and
- Personal, dependent, senior, senior head of household, dependent parent, joint custody head of household, and blind exemption credits.

For a further description of the AMT, refer to Section 12 of Chapter 2C, on the Corporation Tax.

15. TREATMENT OF PENSION AND OTHER RETIREMENT SAVINGS

The tax treatment of pension and other retirement savings plans has two primary elements -- treatment of contributions and treatment of withdrawals. With almost no exceptions, California taxes pension and retirement savings (both contributions and withdrawals) in an identical manner as does the federal government.

Taxation of Contributions. In 2001, Congress enacted the Economic Growth and Tax Relief Reconciliation Act (Public Law 107-16; EGTRRA). Among its many changes, EGTRRA increased the amounts that individuals may contribute to several different types of retirement accounts and added catch-up provisions intended to allow older taxpayers who had not previously fully utilized retirement savings plans to increase their contribution amounts. Significant changes made by EGTRRA are identified in Table 4:

TABLE 4

TYPE OF PLAN	ANNUAL CONTRIBUTION CAPS PRIOR TO EGTRRA	NEW FEDERAL CONTRIBUTION CAPS	NEW, ADDITIONAL CATCH-UP CONTRIBUTIONS FOR PERSONS OVER AGE 50
Individual Retirement Accounts (IRAs)	$2,000	$3,000 in 2002-2004; $4,000 in 2005-2007; $5,000 in 2008; indexed for inflation in $500 increments beginning in 2009	$500 in 2002-2005; $1,000 in 2006 and thereafter
Defined contribution plans (415(c)s)	25% of compensation up to $160,000 or $35,000	100% of compensation or $40,000 in 2003; $41,000 in 2004	
Defined benefit plans (415(b)s)	100% of compensation up to $140,000	100% of compensation up to $160,000 for 2003, $165,000 for 2004	
Elective deferral plans (401(k) plans, 403(b) annuities, SEPs (408(k)s))	$10,500	$11,000 in 2002; $12,000 in 2003; $13,000 in 2004; $14,000 in 2005; $15,000 in 2006; indexed for inflation in $500 increments beginning in 2007	$1,000 in 2002; $2,000 in 2003; $3,000 in 2004; $4,000 in 2005; $5,000 in 2006 and thereafter
SIMPLE plans (408(p))	$6,000	$7,000 in 2002; $8,000 in 2003; $9,000 in 2004; $10,000 in 2005; indexed for inflation in $500 increments beginning in 2006	$500 in 2002; $1,000 in 2003; $1,500 in 2004; $2,000 in 2005; $2,500 in 2006; catch-up contributions are indexed for inflation in $500 increments beginning in 2007
457 elective deferral plans	$8,500	$11,000 in 2002; $12,000 in 2003; $13,000 in 2004; $14,000 in 2005; $15,000 in 2006; indexed for inflation in $500 increments beginning in 2007	$1,000 in 2002; $2,000 in 2003; $3,000 in 2004; $4,000 in 2005; $5,000 in 2006 and thereafter Plus, the limit is twice the standard limit in a participant's last 3 years before retirement.

EGTRRA also increased taxpayers' abilities to roll one type of plan into another type of plan by allowing rollovers among governmental Section 457 plans and Section 403(b) plans, rollovers of IRAs to workplace retirement plans, and rollovers of after-tax retirement plan contributions (e.g., Roth IRAs). Finally, EGTRRA allowed those who have Section 457 plans to use their plan funds to repay contributions and earnings previously refunded to them or to purchase permissive service credits.

California has conformed to all of the pension plan changes enacted by EGTRRA.

Taxation of Withdrawals. As mentioned above, California residents are taxed on all income, including income from sources outside California. An individual who retires in California will pay tax on the pension income that individual receives after becoming a resident, even if that pension was earned while working in another state.

Federal laws prohibit states from taxing nonresidents on pension income received after December 31, 1995. Because California enacted legislation that conforms to the federal preemption, California does not impose a tax on specified pension income received by a nonresident after December 31, 1995, as follows:

- A qualified pension plan described in Internal Revenue Code (IRC) Section 401;
- A qualified annuity plan described in IRC Section 403(a);
- A tax-sheltered annuity described in IRC Section 403(b);
- A governmental plan described in IRC Section 414(d);
- A deferred compensation plan maintained by a state or local government or an exempt organization described in IRC Section 457;
- An individual retirement plan described in IRC Section 7701(a)(37);
- A simplified employee pension (SEP) described in IRC Section 408(k);
- A trust described in IRC Section 501(c)(18);
- Plans, programs, or arrangements described in IRC Section 3121(v)(2)(C), under certain circumstances; and
- Retired or retainer pay of a member or former member of a uniformed service computed under United States Code, Title 10, Chapter 71.

16. SPECIAL FEATURES OF THE PERSONAL INCOME TAX

Unearned Income of Dependent Children ("Kiddie Tax"). Children under age 14 who have net unearned income (i.e., investment income such as dividends, interest, or royalties) of over $1,600 for 2005 are subject to special rules. The purpose of the rules is to prevent shifting of income from parents to children to avoid tax at the parents' rate. The child's unearned income in excess of $1,600 for 2005 is subject to tax at the parents' tax rate, rather than the child's highest tax rate.

Passive Investments. California generally conforms to federal law (IRC Section 469) as that section read on January 1, 2005. Both state and federal law limit the ability of

taxpayers to use passive investment losses to offset or shelter unrelated income. Passive investments are trade or business activities in which the taxpayer does not materially participate. Examples include investment in limited partnerships and other business entities; and rental activities. There is a limited exception for rental real estate activities where the taxpayer actively participates. A taxpayer may meet the requirement of active participation by participating in making management decisions or arranging for services provided by others. California has not conformed to the federal rules for "real estate professionals"; therefore, those taxpayers are still subject to the California passive loss rules.

State and federal laws require the segregation of income and deductions into "active", "passive", and "portfolio" categories. Portfolio income includes interest, dividends, royalties, and gain or loss for the disposition of assets providing portfolio income. Passive activity losses generally may not be deducted against other income, such as wages, salary or portfolio income, or business income that was not derived from passive activities. A similar rule applies to limit passive activity credits.

Current California law treats rental activities (including rental real estate activities) as passive activities, regardless of the level of taxpayer participation. Federal and California law permit the deduction of up to $25,000 of losses from rental real estate activities (even though considered passive) if the taxpayer actively participates in them and certain tests are met. This $25,000 amount is allowed for taxpayers with AGIs of $100,000 or less and is phased out for taxpayers with AGIs between $100,000 and $150,000. Deductions and credits suspended under these rules are treated as suspended losses or credits from a passive activity and can be carried forward to years in which there is passive income. Any remaining carry forwards is allowed in full when a taxpayer disposes of his or her entire interest in the passive activity to an unrelated taxpayer.

Taxpayers must adjust the amount of California passive activity losses for differences in other areas of state law (e.g., depreciation). Also, nonresidents and part-year residents must make adjustments to passive activity items in computing California source AGI.

Other Special Provisions That Affect Businesses. There are other special provisions in the Personal Income Tax Law that primarily affect business taxpayers. Several of these are described in the Bank and Corporation Tax chapter (Chapter 2C).

17. MINIMUM CORPORATE FRANCHISE TAX

Most corporations taxable by California are subject to a minimum franchise tax. This is a specified dollar amount that businesses must pay even if their tax liability based on net income is lower. See Section 4 of the Corporation Tax chapter for more information on the franchise tax.

Personal income taxpayers are not subject to a minimum tax. However, certain entities taxed under the Personal Income Tax Law are subject to an annual tax equal to the minimum franchise tax. These include limited partnerships, limited liability partnerships, certain limited liability companies, and real estate mortgage investment conduits (REMICs).

18. VOLUNTARY CONTRIBUTIONS

California allows taxpayers to make voluntary contributions of their own funds to one or more organizations listed on the state tax return by checking a box on their return. These eligible activities are often called "check-offs", although they are not like the federal check-offs that allow taxpayers to direct a portion of their tax liability to the selected organization. These contributions allowable on California tax returns are deductible as charitable contributions on the following year's tax return for taxpayers that itemize deductions.

For the 2005 tax year, 14 check-offs will appear on the individual income tax form. The number of check-offs on the tax form has grown in recent years to the point where the form is very close to exceeding its current two-page length. Going to a three-page form would be extremely costly for the state due to increased printing and processing costs. Initially, the Legislature responded to the proliferation of check-offs on the tax form by requiring check-offs to have sunset dates and to meet minimum annual contribution amounts. More recently, the Legislature has begun to require new check-offs to wait in line to be added to the form until old check-offs are removed (so-called "queuing language"). The current rules regarding the standards each check-off must meet in order to remain on the form are summarized in the following chart:

Fund	Sunset Date	Must Meet Minimum Contribution?
California Fund for Senior Citizens	1/1/10	$250,000, increased annually for inflation beginning in 2002
Fish and Game Preservation Fund	1/1/08	$250,000, increased annually for inflation beginning in 2003
State Children's Trust Fund	1/1/08	$250,000, increased annually for inflation beginning in 2003
Alzheimer's Disease and Related Research Fund	1/1/10	$250,000, increased annually for inflation beginning in 1992
California Seniors Special Fund	None	No
California Breast Cancer Research Fund	1/1/08	$250,000, increased annually for inflation beginning in 1998
California Firefighters' Memorial Fund	1/1/06	$250,000 only if sunset date is deleted (no inflation factor)
Emergency Food Assistance Fund	1/1/09	$250,000, increased annually for inflation beginning in 2000
California Peace Officer Foundation Memorial Fund	1/1/06	$250,000, annually increased for inflation beginning in 2001, only if sunset date is deleted
California Military Relief Fund	1/1/10	$250,000, increased annually for inflation beginning in 2006
California \Prostate Cancer Research Fund	1/1/10	$250,000, increased annually for inflation beginning in 2006
California Sexual Violence Victim Services Fund	1/1/11	$250,000, increased annually for inflation beginning in 2007
Veterans Quality of Life Fund	1/1/11	$250,000, increased annually for inflation beginning in 2007
California Colorectal Cancer Prevention Fund	1/1/11	$250,000, increased annually for inflation beginning in 2007

19. REVENUE

The personal income tax is the largest single source of revenue for the State of California. Revenues were $42.7 billion in 2004-05 (53.4% of state General Fund revenues). Revenues are expected to be $45.5 billion in 2005-06.

20. ADMINISTRATION

The FTB administers the personal income tax. Returns are due annually on the 15th day of the fourth month following the close of each taxable year (typically April 15th). Individuals are automatically granted an extended filing period of six months for submitting their tax returns but are not relieved of their obligation to pay the tax due by

April 15. Taxpayers who do not pay 100% of their tax liability by April 15 owe interest and are assessed a late payment penalty. Similarly, taxpayers who do not file by the extended due date (typically October 15th) are assessed a penalty for failure to file. However, taxpayers who do file on or before the extended due date are not penalized for failure to file.

Salaries and wages are subject to withholding by employers. The Employment Development Department (EDD) administers withholding. If taxpayers have a significant amount of income that is not subject to withholding (such as from self-employment income or investments), they must pay estimated taxes in quarterly installments in order to ensure that they remit sufficient funds throughout the course of the year to avoid penalties for failure to timely pay. Taxpayers may be subject to penalties if amounts remitted over the course of the year through withholding and/or estimated payments are less than prescribed minimum percentages of their total tax liability.

The amount of tax due in excess of the amount withheld and/or paid as an estimated payment is due on April 15th. If a taxpayer overpays during the year through withholding and/or estimated payments, he or she can direct FTB to apply the overpayment to the next year's liability or to refund the overpayment by check.

21. CODE

California Constitution, Article III, Section 26

Revenue and Taxation Code, Division 2, Part 10, Section 17001 et. seq., and Part 10.2, Sections 18401-19802