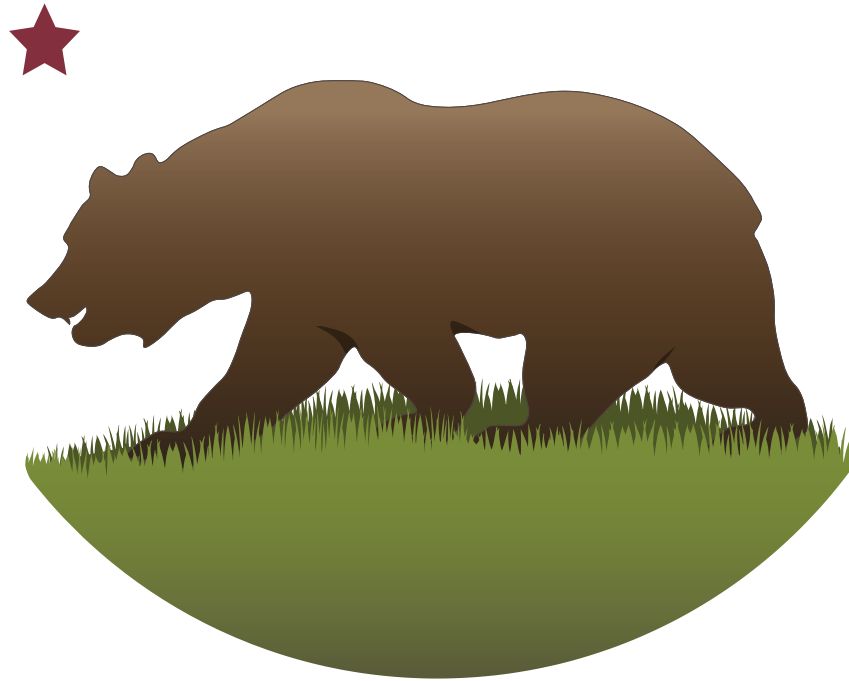


# CALIFORNIA'S TAX SYSTEM

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## A V I S U A L G U I D E



LEGISLATIVE ANALYST'S OFFICE

# INTRODUCTION

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California's state and local governments rely on three main taxes. The personal income tax is the state's main revenue source, the property tax is the major local tax, and the state and local governments both receive revenue from the sales and use tax. In addition, many smaller taxes raise revenue for state and local government operations. In 2015-16, taxes in California raised a total of \$220 billion—equal to nearly 10 percent of the state economy.

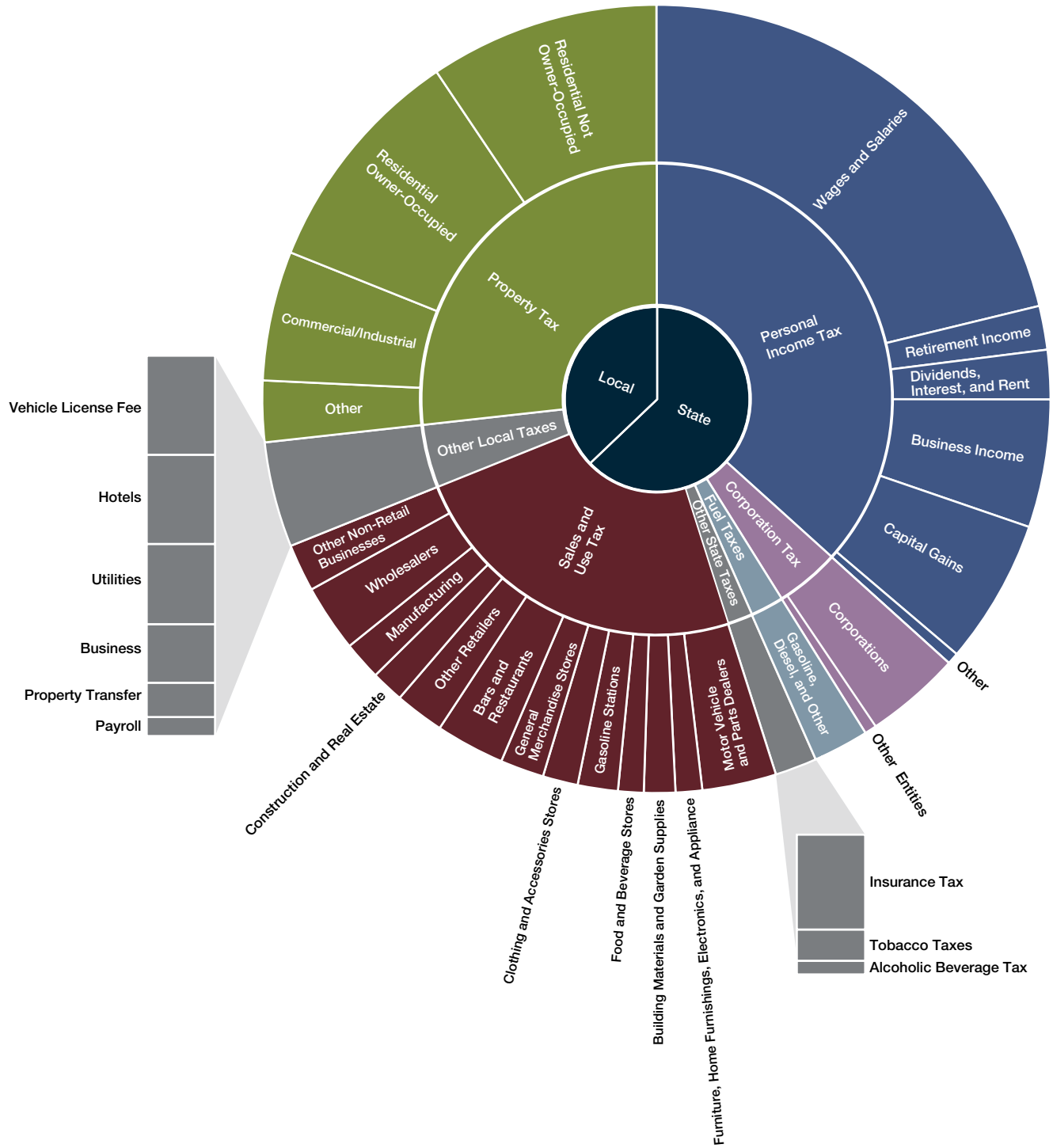
The chart to the right summarizes this tax system. The inner black pie chart shows that roughly two-thirds of tax revenues in California go to the state government with the other one-third collected by local governments. The middle ring shows each tax as a share of the whole system. (Note that the line from the inner black pie chart intersects with the sales and use tax segment to show the shares of sales tax revenue that go to the state and to local governments.) The outer ring breaks out each major tax by source. For example, the biggest source of personal income tax revenue is wage and salary income.

In addition to taxes, the state and local governments rely on federal funds, fees, and other sources of revenue to fund government operations. This publication, however, focuses solely on taxes levied in California.

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# OVERVIEW OF CALIFORNIA'S TAX SYSTEM

2015-16



C H A P T E R

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1



# PERSONAL INCOME TAX

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The personal income tax (PIT) is a broad-based tax that the state levies on most types of income, such as wages and capital gains. The PIT is an important revenue source for the state government, generating over two-thirds of the revenue for the General Fund—the state’s main operating account. In recent years, the PIT has generated more revenue than any other tax in California’s tax system.

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# ABOUT TWO-THIRDS OF INCOME COMES FROM WAGES AND SALARIES

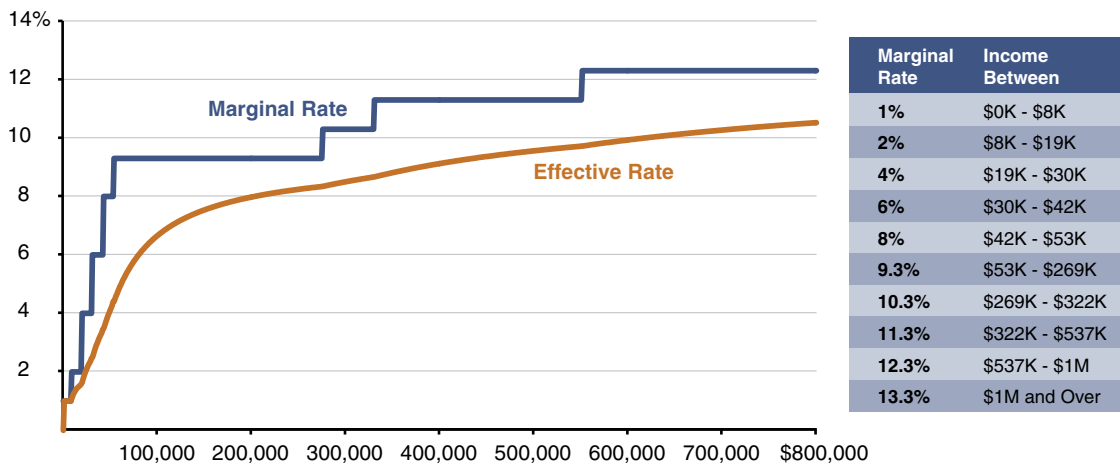
2015



## HOW DO PIT RATES WORK?

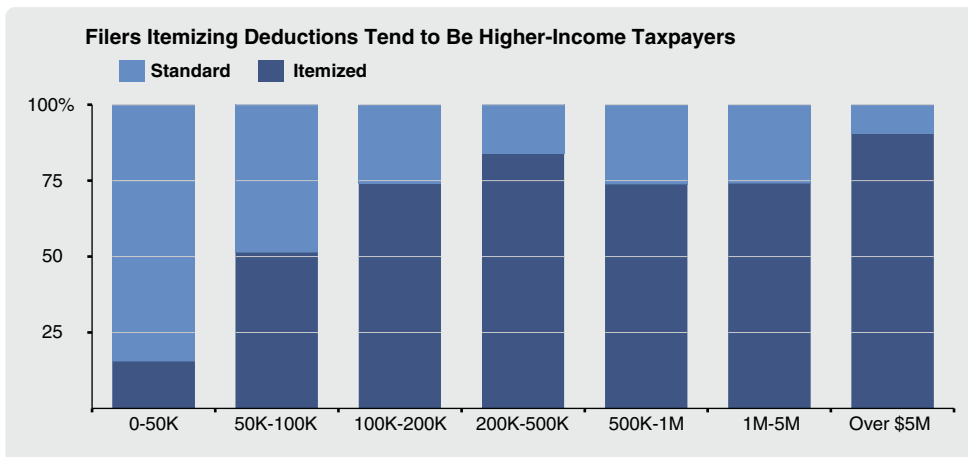
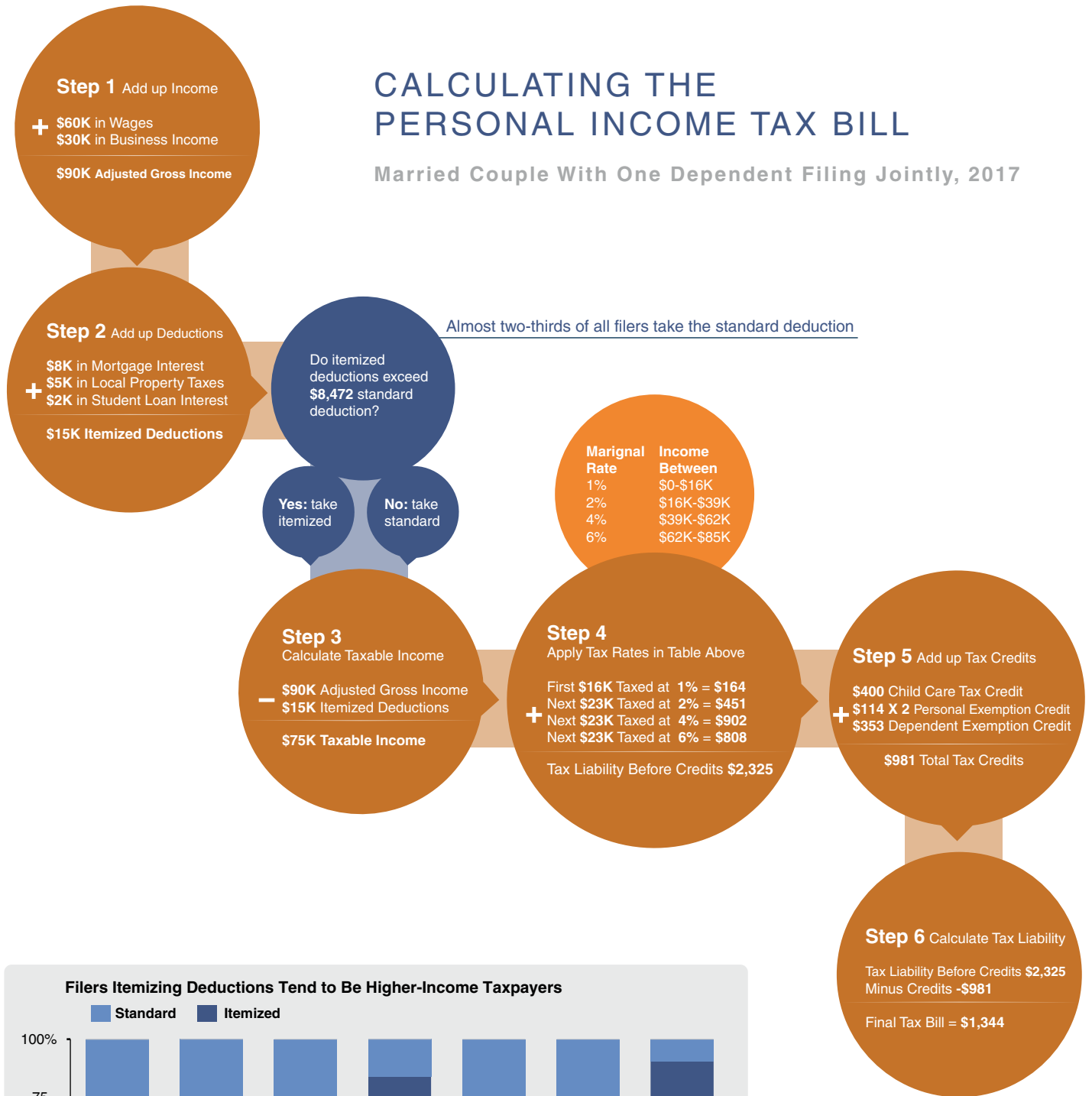
Marginal and Effective Tax Rates, Single Filer, 2017

Personal income tax rates are marginal, meaning that higher income increments are taxed at higher rates. For example, a single filer with taxable income of \$300,000 is taxed at 1 percent on the first \$8,000 of their income, but 10.3 percent on the last \$31,000 of their income. A taxpayer's highest marginal rate is higher than their effective rate (the average rate at which their income is taxed). For example, a single filer with \$100,000 in taxable income is taxed at 9.3 percent on their last dollar of income but their effective tax rate (before tax credits) is 6.7 percent.



# CALCULATING THE PERSONAL INCOME TAX BILL

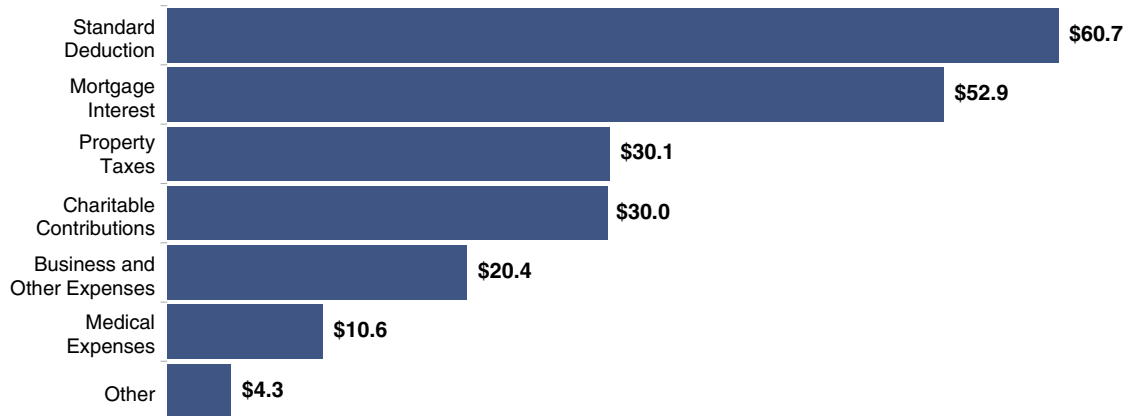
Married Couple With One Dependent Filing Jointly, 2017



## BREAKDOWN OF DEDUCTIONS

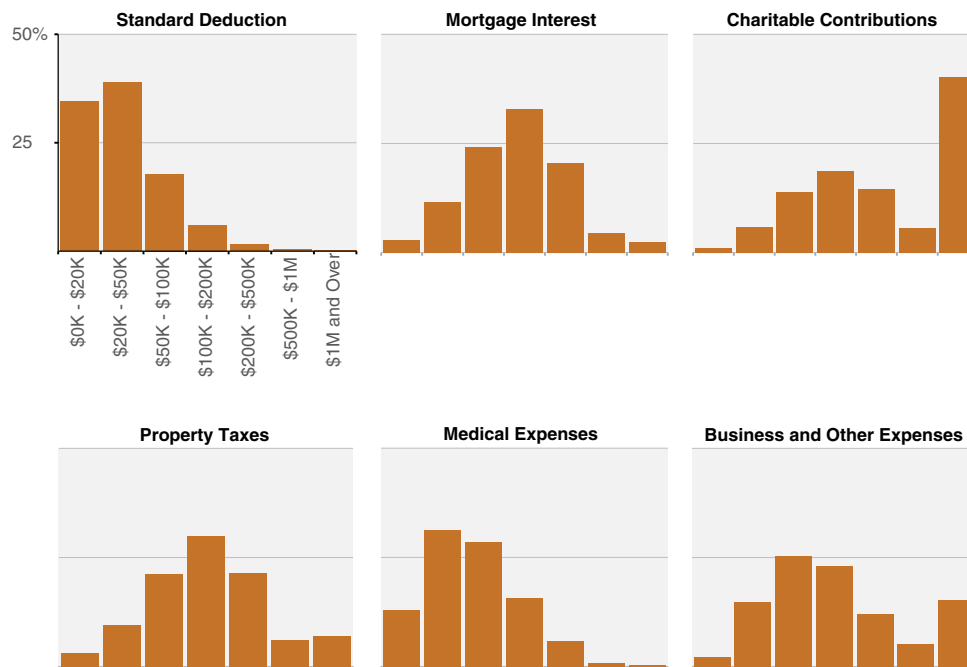
In Billions, 2015

PIT deductions reduce taxpayers' taxable incomes. In total, deductions reduced taxable income by about \$200 billion in 2015. About \$7 billion of the deductions shown here went unused because itemized deductions are phased out for high-income taxpayers.



## WHO USES DEDUCTIONS?

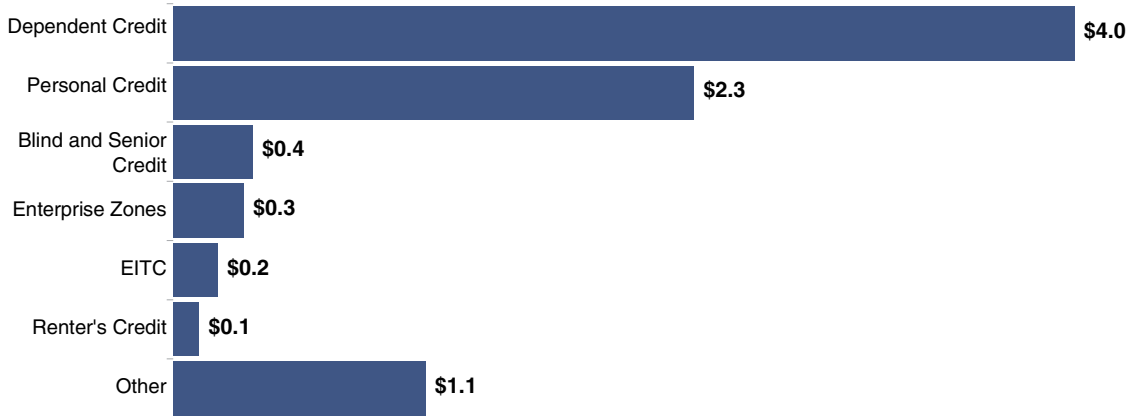
Share of Deduction Value by Income Group, 2015



# BREAKDOWN OF CREDITS

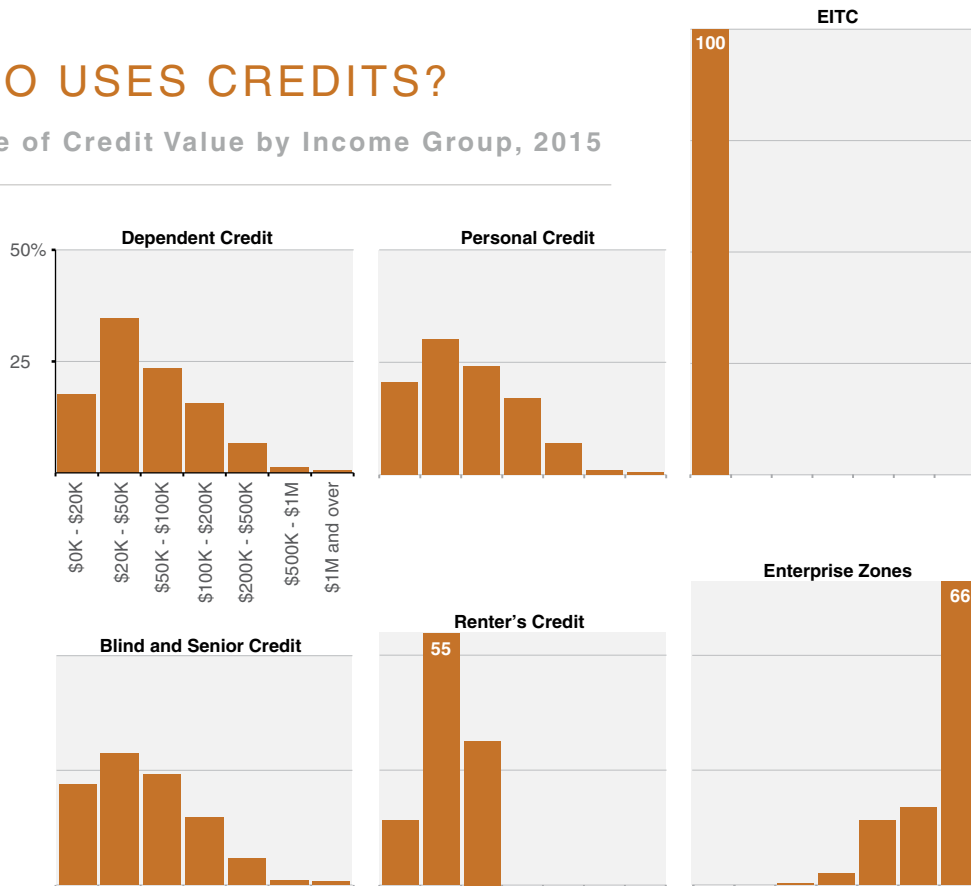
In Billions, 2015

PIT credits reduce tax liabilities dollar for dollar, resulting in a dollar-for-dollar reduction in state revenue. With the exception of the Earned Income Tax Credit (EITC), credits cannot reduce a taxpayer's liability below zero. For this reason, the amount of credits shown in the chart is about double the amount of credits actually used by taxpayers to reduce liability.



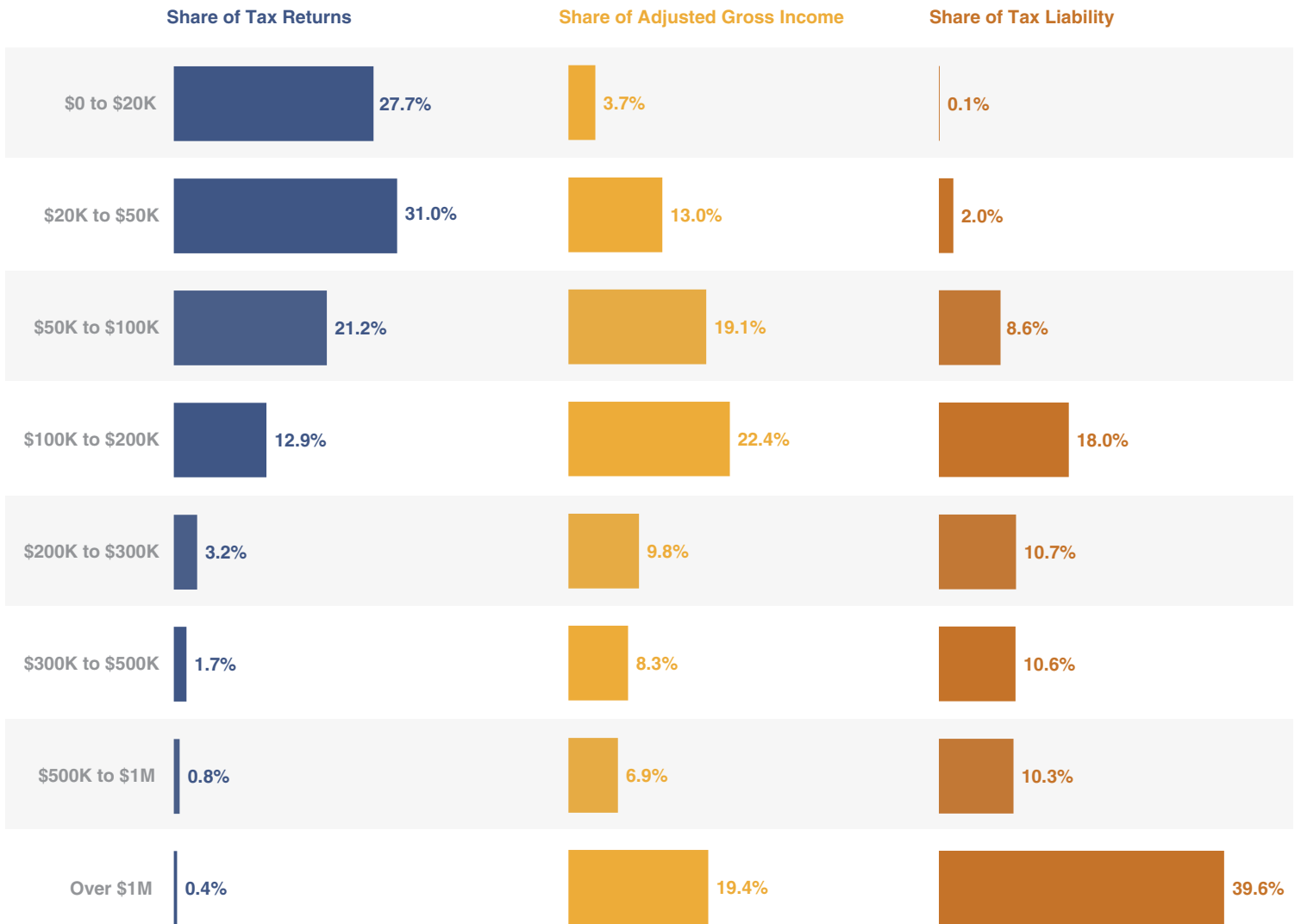
## WHO USES CREDITS?

Share of Credit Value by Income Group, 2015

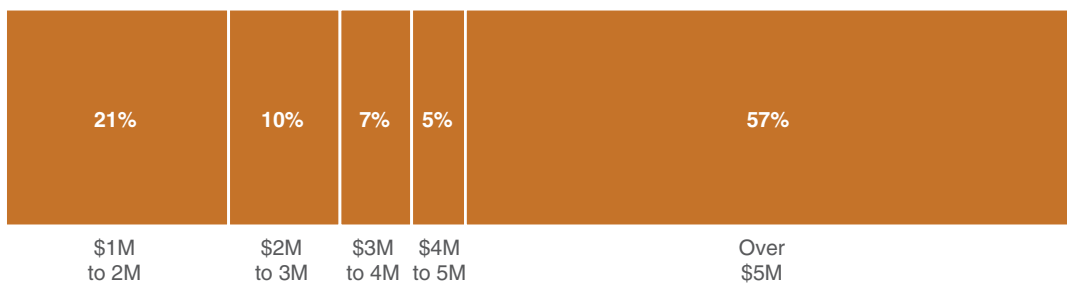


# PIT LIABILITY CONCENTRATED AMONG TOP EARNERS

Tax Statistics by Income Group, 2015



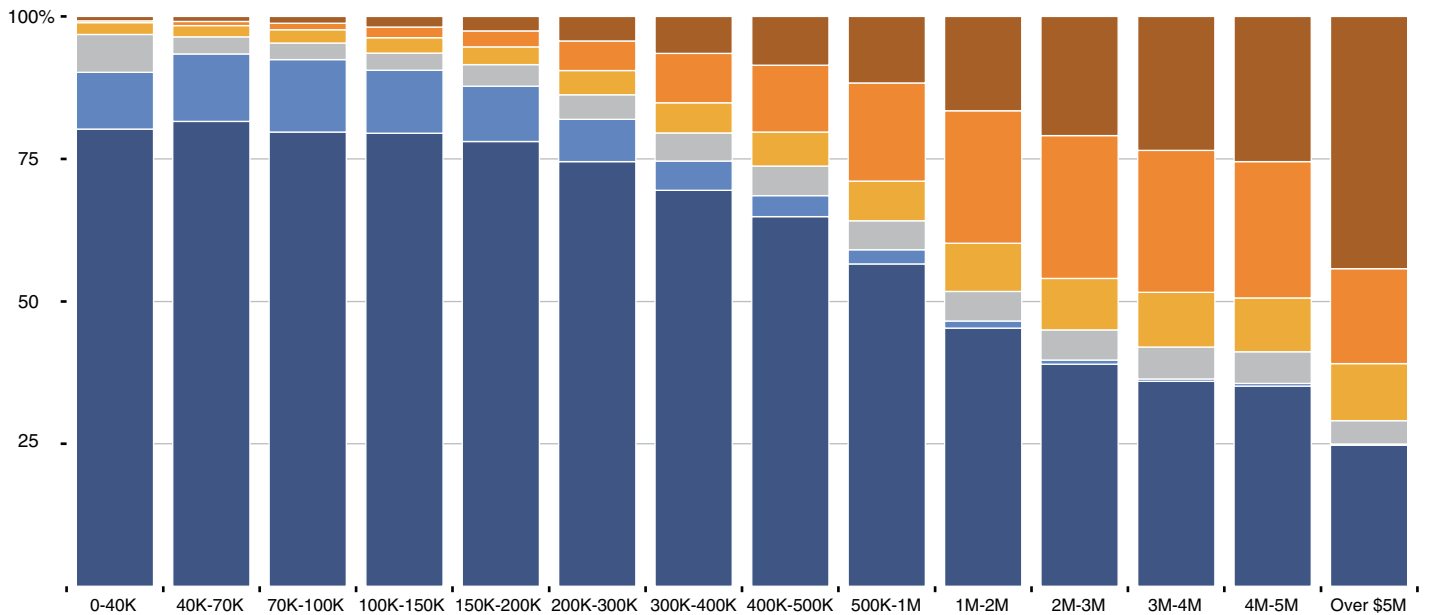
**Over Half of PIT Liability for Over \$1 Million Group Paid by Filers With Adjusted Gross Income Over \$5 Million**



# INCOME MAKEUP DIFFERENT FOR LOW- AND HIGH-INCOME TAXPAYERS

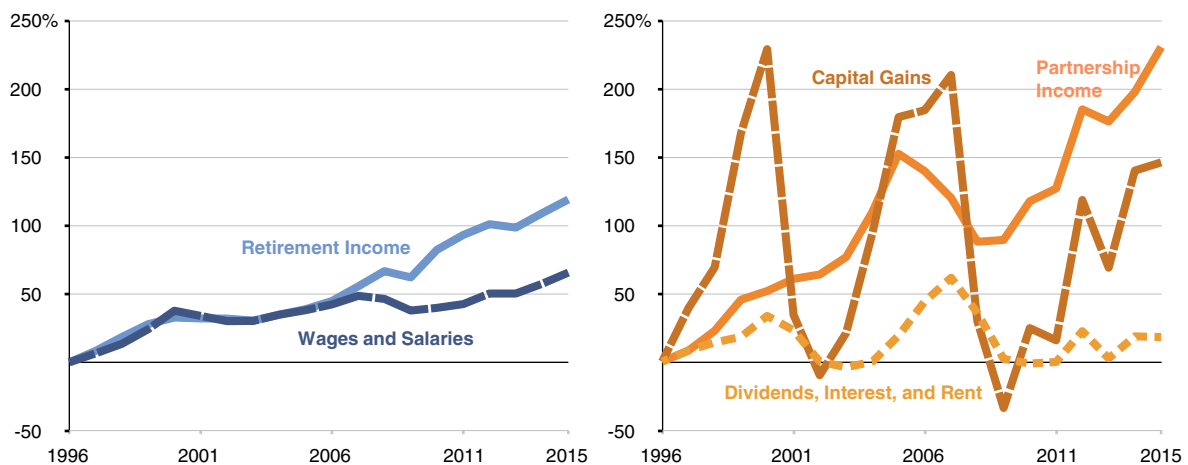
2015

The graphic below shows how taxpayers in different income groups derive their income. Some types of income, including **wages and salaries** and **retirement income** (pensions, annuities, and IRA distributions) make up the majority of low- and middle-income taxpayers' incomes. These sources, however, account for a minority of the total incomes of the highest-income taxpayers, whose incomes are derived mostly from **capital gains, partnership income, and dividends, interest, and rent**. (All other income—mostly proprietors' income—is shown in grey.)



## HIGH-INCOME TAXPAYERS RELY MORE ON VOLATILE INCOME SOURCES

Total Percent Change, 2015 Dollars



## PIT MORE VOLATILE THAN PERSONAL INCOME

### Annual Percent Change

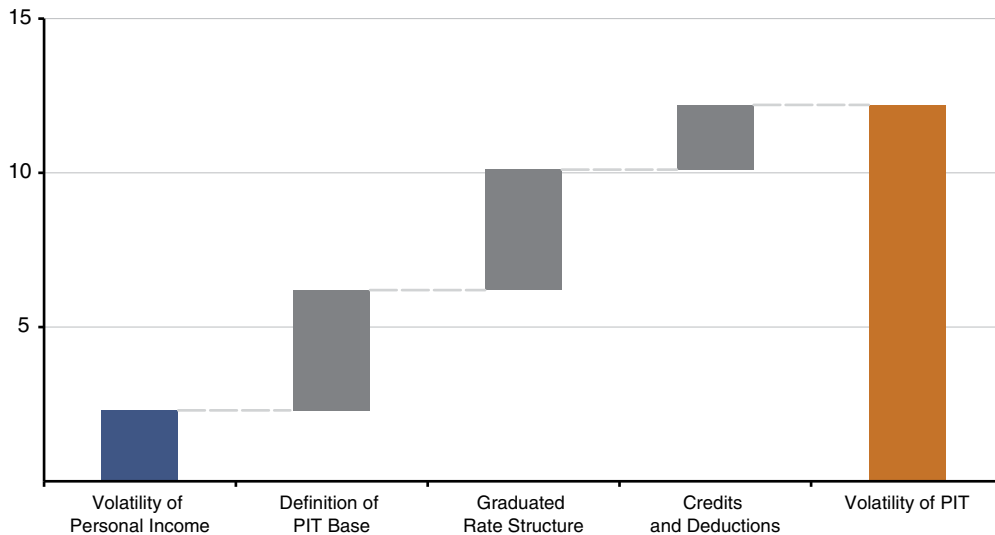
As the state's main revenue source, the highly volatile PIT results in revenue uncertainty, thus complicating state budgeting. (Personal income is an overall measure of the economy that includes individuals' wages, business income, and various other types of income, but that excludes capital gains income.)



## CAUSES OF PIT VOLATILITY

### Average Deviation, 1990 to 2014

Average deviation (AD) is a measure of revenue volatility. With an AD of 12.2, the PIT is over five times more volatile than personal income (2.3). About 40% of the higher volatility is due to the state's choices about which types of income to tax. Another 40% is due to taxing higher income at higher rates. The last 20% comes from PIT credits and deductions, which mostly reduce the relatively stable part of the tax base.

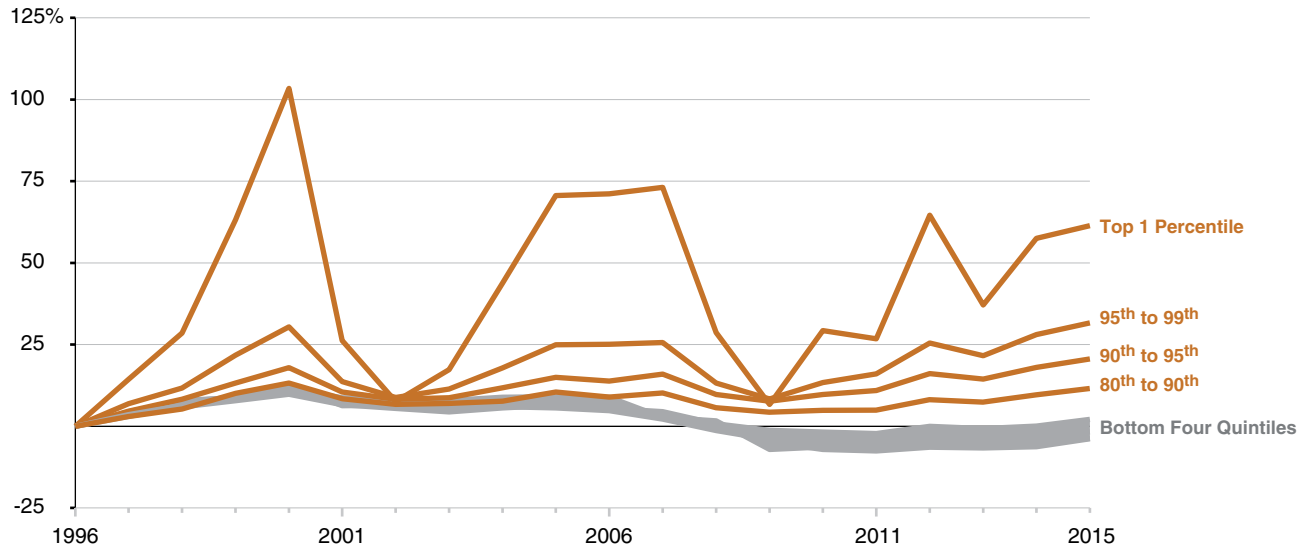


## WITH VOLATILITY COMES GREATER REVENUE GROWTH

The top 1% of taxpayers typically pay between 40% and 50% of the PIT. Their incomes are highly volatile, which has contributed to PIT volatility. On the other hand, their incomes also have grown more than any other group of taxpayers. This has contributed to PIT growth.

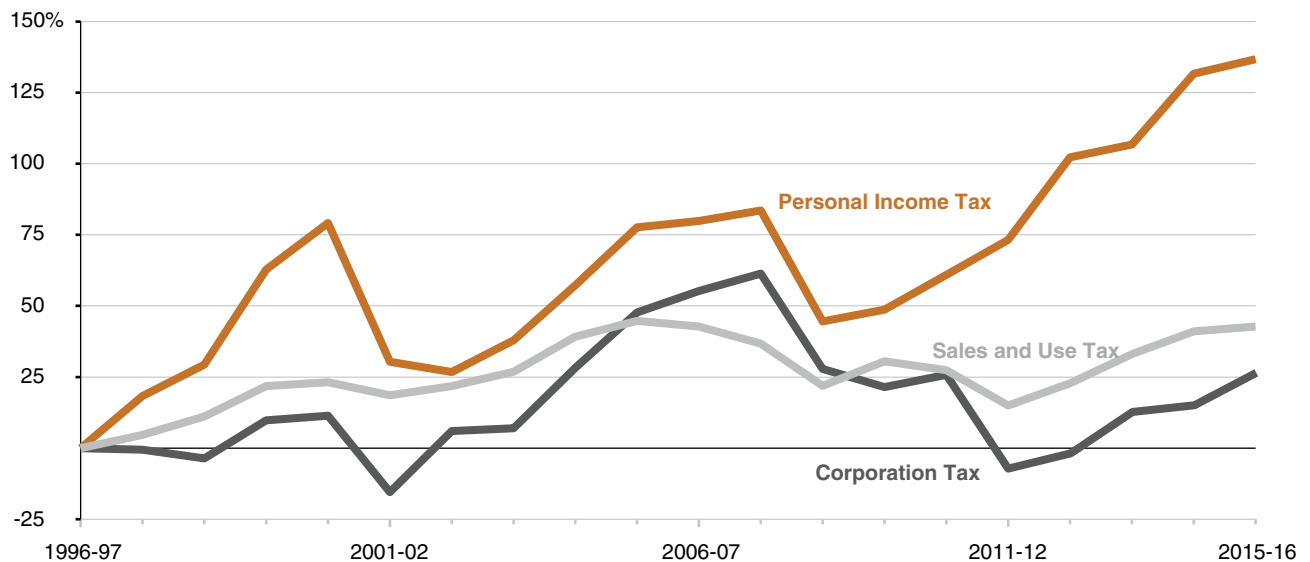
### Bulk of Income Growth Has Gone to High-Income Taxpayers...

Adjusted Gross Income Per Return by Income Range, Total Percent Change, 2015 Dollars



### ...Which Has Contributed to PIT Revenues Growing Much Faster Than Revenues From Other State Taxes

Total Percent Change, 2015-16 Dollars



## VOLATILITY OF THE PIT BASE

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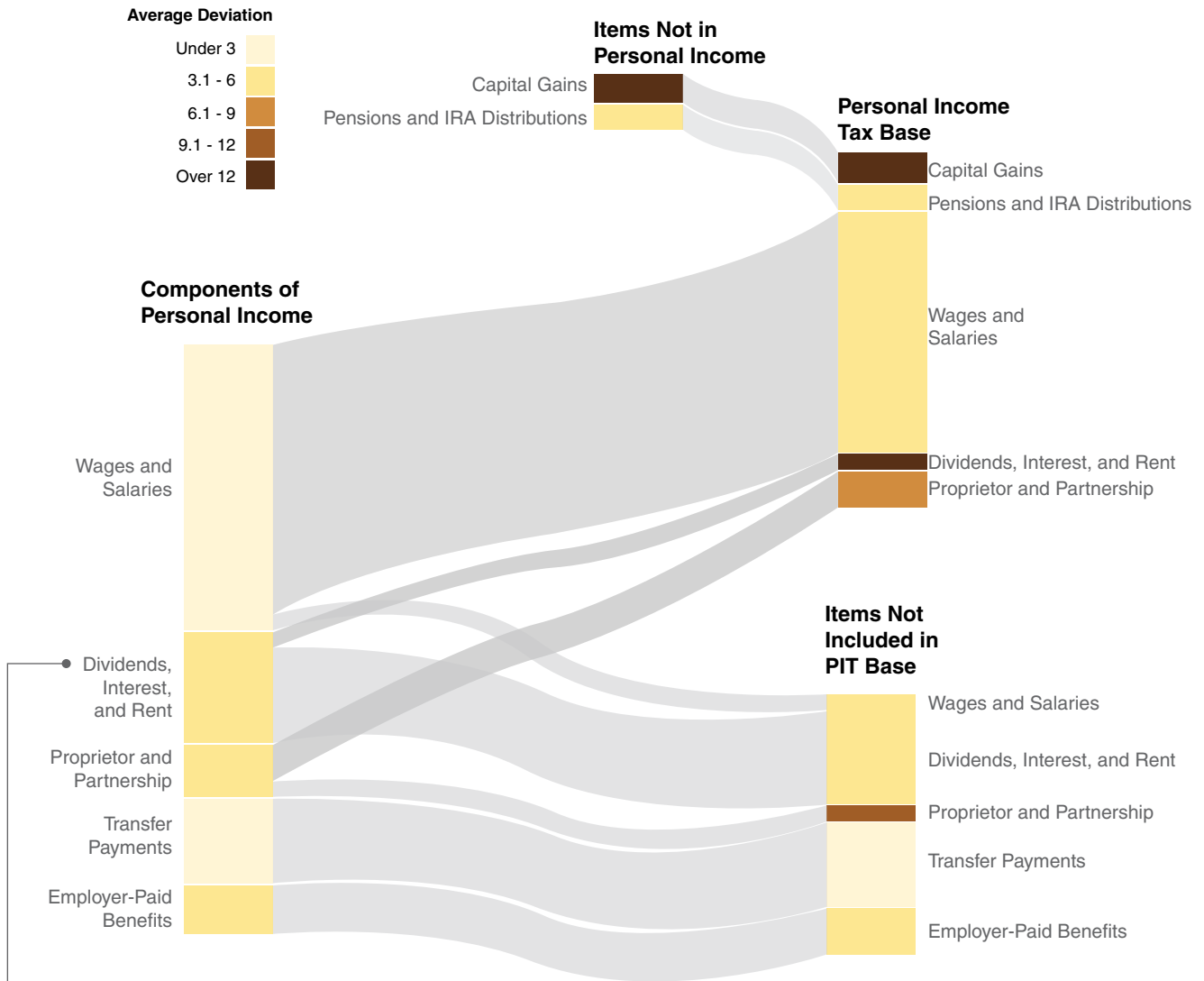
State law specifies which types of income are subject to the personal income tax. In general, California has chosen to tax relatively volatile types of income, as illustrated by the chart on the next page. The boxes are shaded by their volatility measure (average deviation). An item with a measure of 6 is twice as volatile as an item with a measure of 3.

Personal income is an economic statistic that includes most types of income. Different portions of personal income are subject to tax. Some portions of personal income are more volatile than others. For example, the portion of dividends, interest, and rent flowing to the PIT base is more volatile (darker) than the portion not in the PIT base. California also chooses to tax some types of income not included in personal income. In particular, capital gains income, with a volatility measure of 35, is more than twice as volatile as any other part of the PIT base. Overall, the PIT base is almost three times as volatile as personal income.

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# PIT BASE MORE VOLATILE THAN PERSONAL INCOME

Average Deviation, 1990-2014



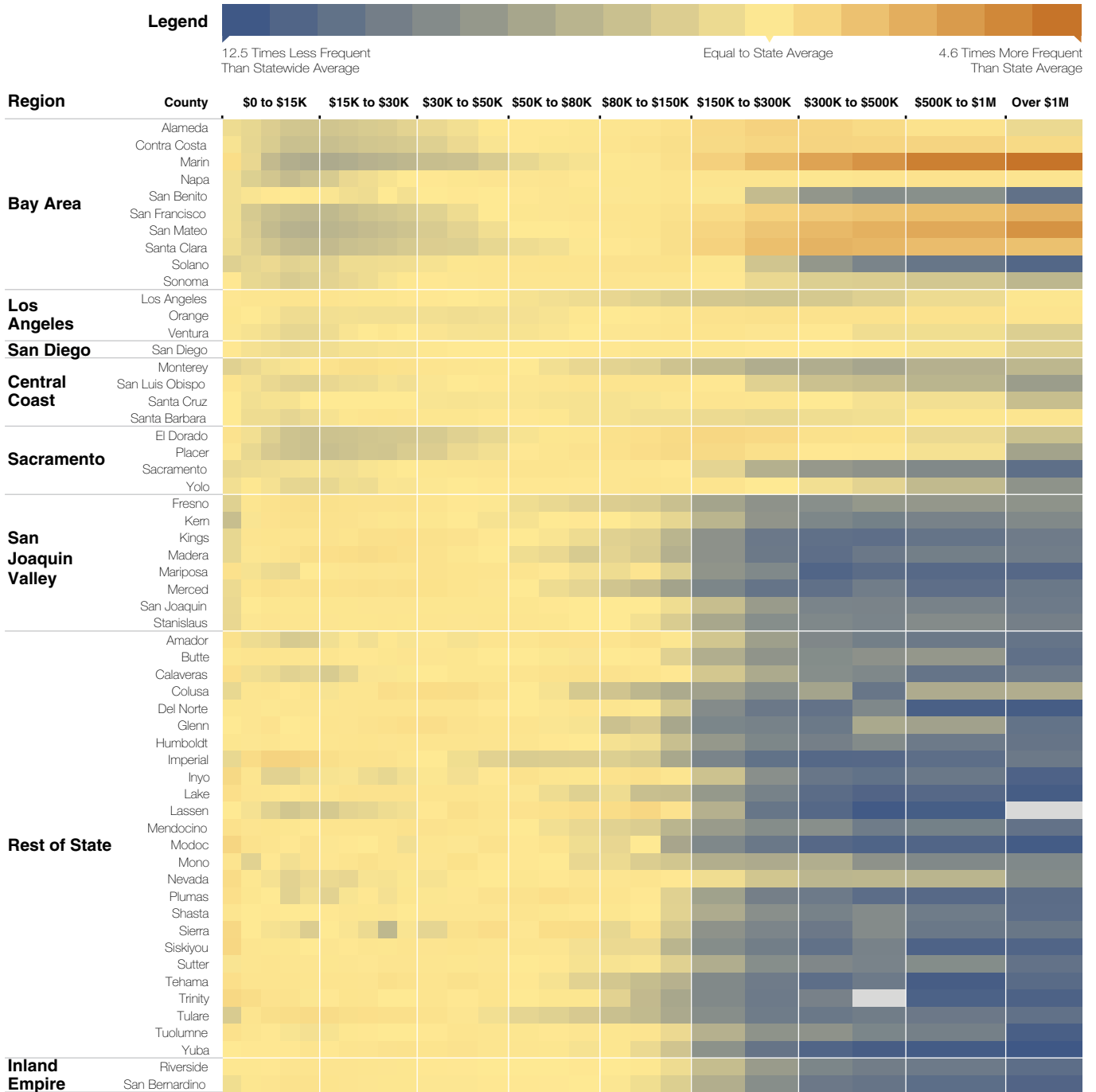
• Within these broad categories, some components of personal income are in the tax base and others are untaxed. For example, interest earned from corporate bonds is taxed but interest earned from municipal bonds is untaxed.



# HIGHER INCOMES CONCENTRATED IN BAY AREA

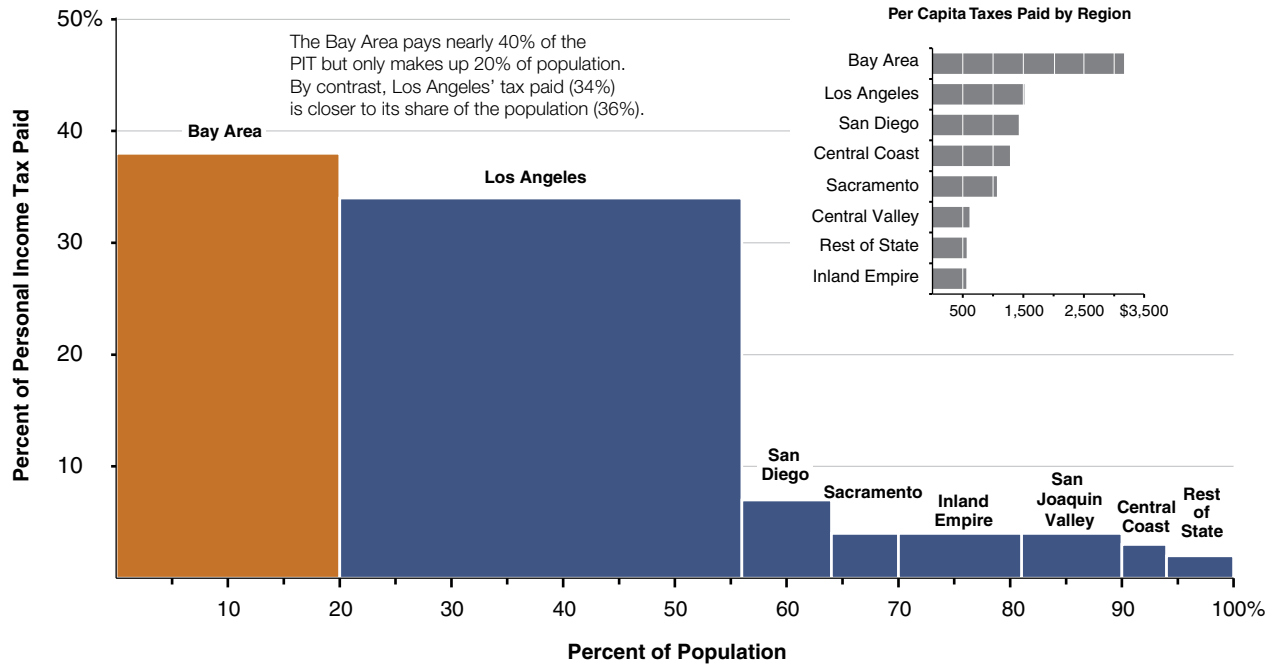
2013

The graphic below shows how incomes by county compare to the statewide average. A blue shade indicates that a county has fewer taxpayers in that income range, a yellow shade indicates the county is near the statewide average, and an orange shade indicates they have more taxpayers in that range. Compared to the statewide average, Marin county has 4.6 times more taxpayers in the over \$1 million range, the most of any county.



# BAY AREA CONTRIBUTES DISPROPORTIONATELY TO PIT

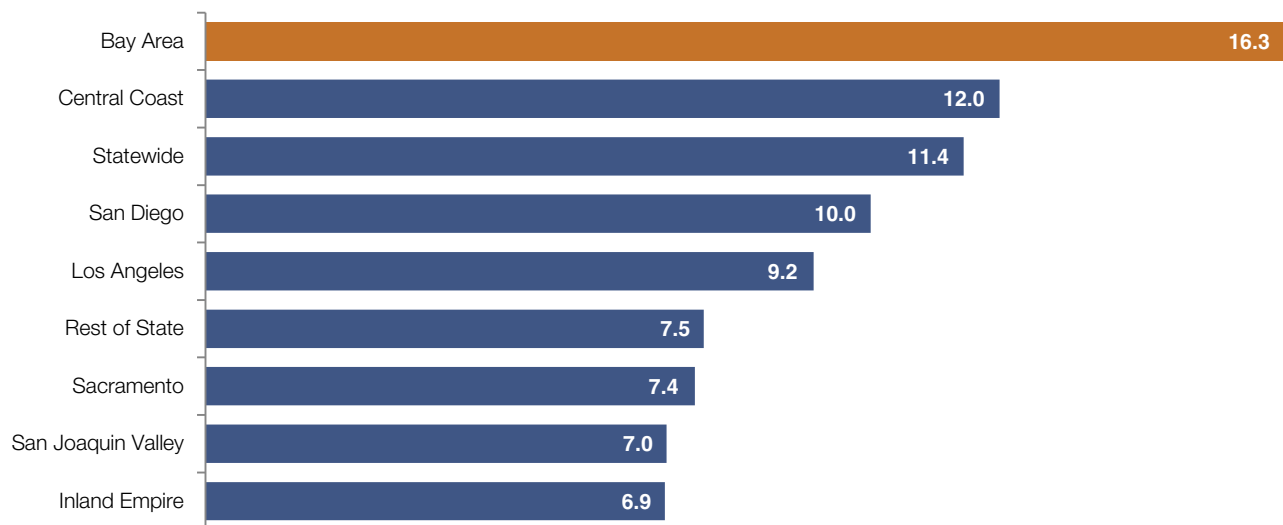
2014



## PIT PAID BY BAY AREA MORE VOLATILE THAN REST OF STATE

Average Deviation, 1996-2014

Average deviation (AD) is a measure of revenue volatility. With an AD of 16.3, personal income tax paid by Bay Area residents from 1996-2014 was over 40 percent more volatile than for tax paid statewide (11.4).





C H A P T E R

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2



# PROPERTY TAX

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For many California taxpayers, the property tax bill is one of the largest tax payments they make each year. For thousands of California local governments—K–12 schools, community colleges, cities, counties, and special districts—revenue from property tax bills represents the foundation of their budgets. Cities, counties, and special districts use property tax revenues to support municipal services like police, fire, and parks. Property tax revenue remains in the county in which it is raised.

Property taxes are levied by local governments on real property (principally land and buildings), as well as some types of personal property, which includes business property (like manufacturing equipment), aircrafts, and vessels. Proposition 13 (1978) limits the property tax on real property to 1 percent of assessed value. Under Proposition 13, assessed value for real property is limited to the price paid for the property increased each year by 2 percent or inflation, whichever is lower. In contrast, personal property is taxed based on its market value. In 2016-17, statewide property tax revenues were about \$60 billion.

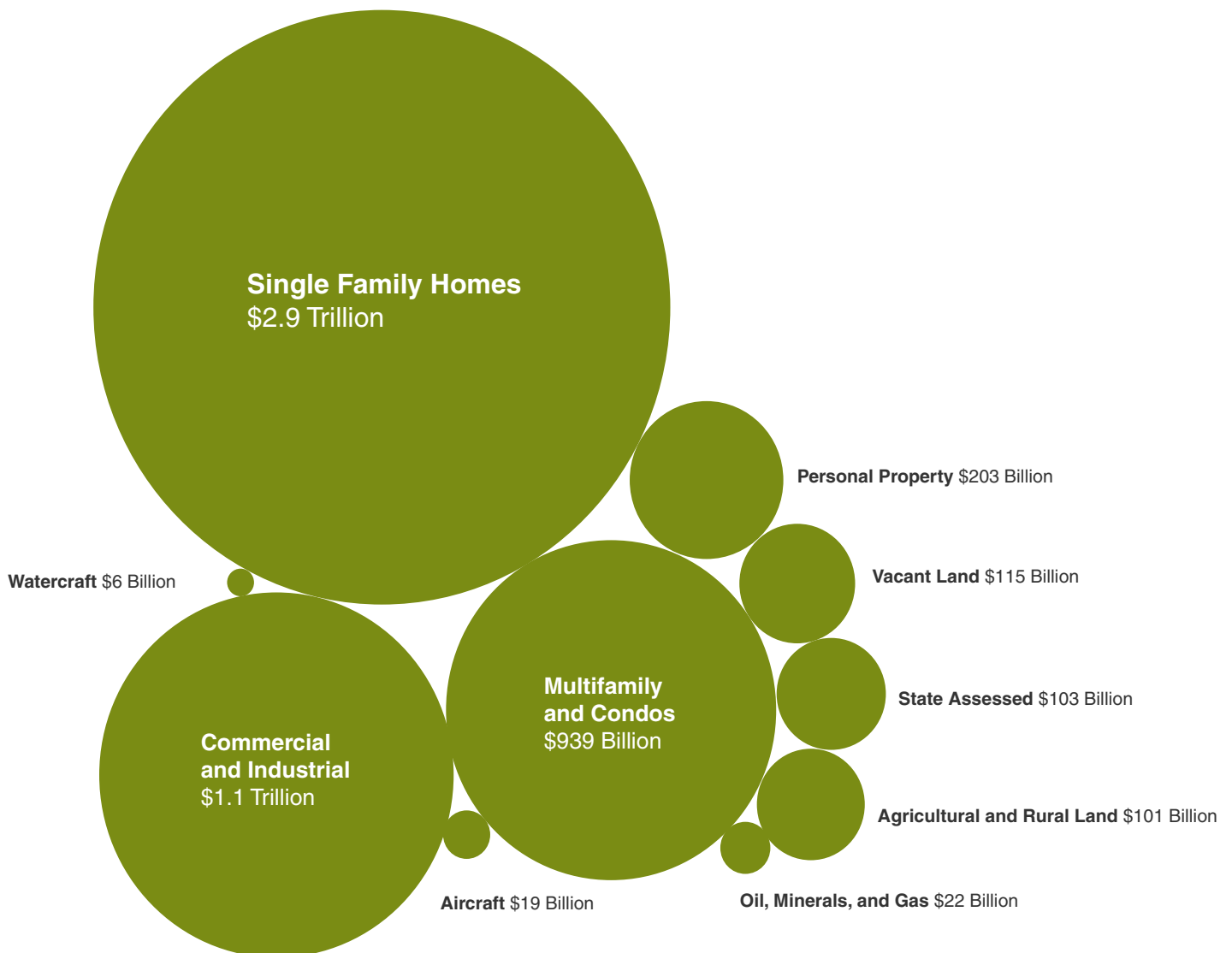
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## WHAT IS SUBJECT TO THE PROPERTY TAX?

2016-17

This figure shows the assessed value of each type of property subject to the property tax. In most cases, county assessors determine the value of property within the county. For a subset of property—like natural gas pipelines—the state determines the value of the property. Statewide, the assessed value of taxable property is over \$5.7 trillion.



## SAMPLE ANNUAL PROPERTY TAX BILL

Property Owner Information		Detail of Taxes Due		
<b>Property ID:</b> 1234567 <b>Mailing Address:</b> Doe, Jane 1234 ABC Street Sacramento, CA 00000		<b>Agency</b>	<b>Rate</b>	<b>Amount</b>
<b>Property Valuation on Jan 1, 2012</b>		<b>General Tax Levy</b>	1.0000	\$3,500.00
<b>2016-17 Roll</b>	<b>Assessed Value</b>	<b>Voter-Approved Debt Rates</b>		
Land	\$115,000.00	City	0.0201	\$70.35
Improvements	\$242,000.00	Water District	0.0018	6.30
Total	\$357,000.00	School District	0.1010	353.50
Less Exemptions	\$7,000.00	Community College District	0.0102	35.70
Net Assessed Value	\$350,000.00	<b>Direct Levies</b>		
		Sidewalk District Assessment		\$9.36
		Flood Control District Assessment		64.39
		Street Lighting District Assessment		12.71
		Mello-Roos District		86.51
		School District Parcel Tax		125.00
		<b>Total Taxes Due</b>		<b>\$4,263.82</b>
		1st Installment		\$2,131.91
		2nd Installment		2,131.91

### Exemptions

Certain exemptions can reduce a property's assessed value. The most common is the homeowner's exemption, which reduces an owner-occupied home's assessed value by \$7,000.

### Taxable Value

Each year, county assessors determine each property's assessed value, which includes the value of both land and buildings. Assessed value typically is based on a property's purchase price. In the year a property is purchased, it is taxed at its purchase price. Each year thereafter, its assessed value is increased by inflation or 2 percent, whichever is lower. Upon resale, it is again taxed at its purchase price. If a property's market value dips below its inflation-adjusted purchase price, it is typically taxed on its market value instead.

### Total Payment

County tax collectors divide properties' total tax bill into two payments. The first payment is due by December 10<sup>th</sup> and the second payment is due by April 10<sup>th</sup>. Many homeowners pay their property taxes as part of their monthly mortgage and their mortgage servicer pays the county on the homeowners' behalf.

### Other Taxes and Charges

Local governments may levy other charges on property that are not ad valorem taxes. Often, these charges are based on the benefits the propertyowner receives from the service or improvement.

### Ad Valorem Taxes

Taxes based on the value of property are known as ad valorem taxes. Proposition 13 capped the ad valorem property tax rate at 1 percent plus voter-approved add-on rates to for certain debt repayments.

# THE LIFE OF A HOUSE

This graphic shows the value of a hypothetical home over time to demonstrate how different transactions and changes to a property affect a property owner's tax bill.

**Market Value**

The price the home could be sold for.

**Assessed Value**

The basis of the property owner's tax bill.



**2008: Decline in Value**

The home's market value dips below its inflation-adjusted purchase price. Proposition 8 (1978) allows the home to be temporarily assessed based on its market value instead.



**1978: Proposition 13**

Proposition 13 (1978) requires a home's assessed value to be based on its purchase price, increased by up to 2 percent per year for inflation. Whenever it is sold, it is again taxed at its purchase price. Proposition 13 also rolled back assessed values to their 1975 levels.



**1988: Transfer to Child**

A property transfer typically triggers a reassessment. However, Proposition 58 (1986) allows the home to transfer from the owner to the child without a reassessment to market value.



**1970: Home Purchased**

From 1970 to 1977 the home is taxed based on its market value.



**1985: Bedroom Added**

The addition of a bedroom increases the home's assessed value to reflect the added market value of the bedroom but not that original home.



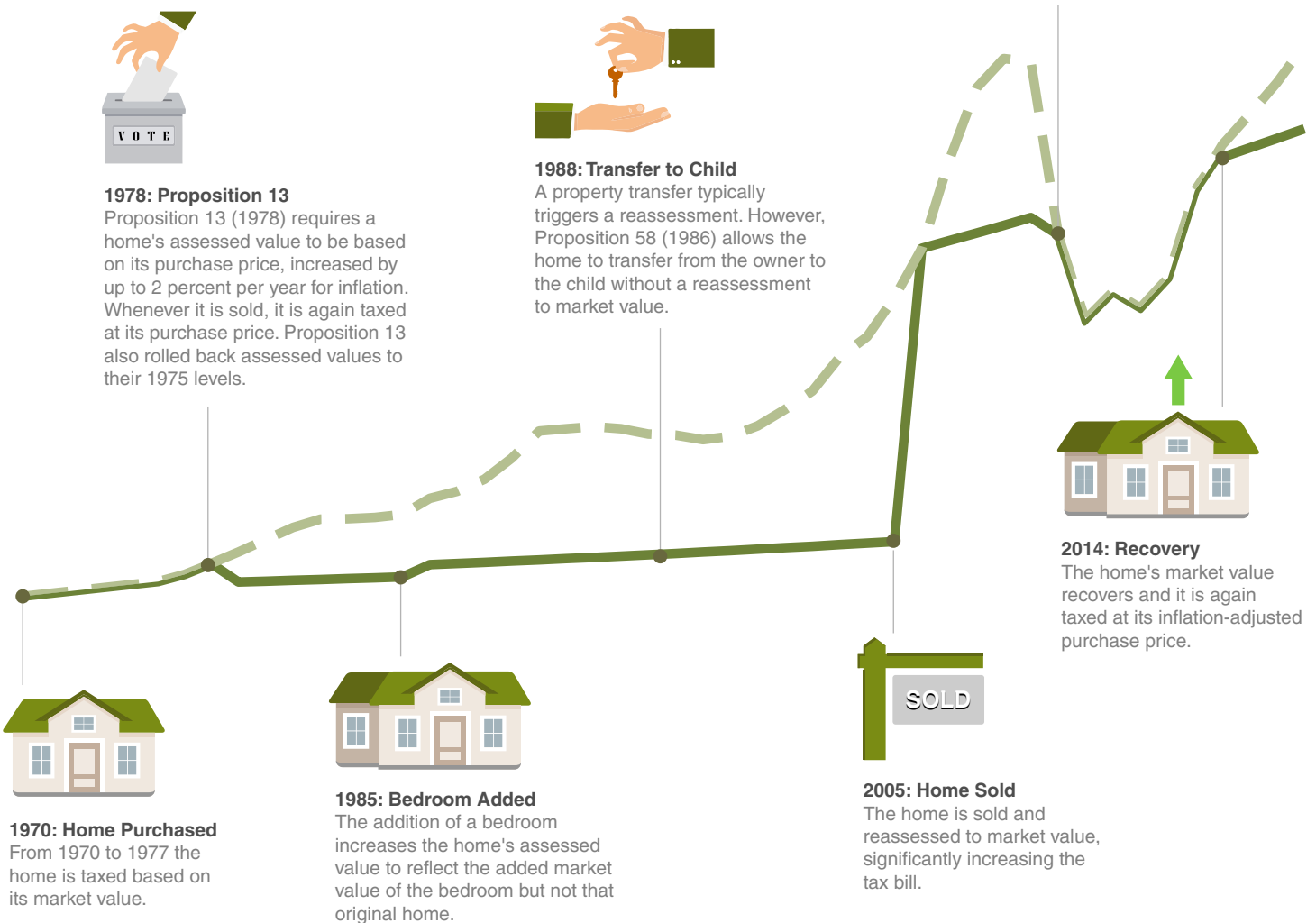
**2005: Home Sold**

The home is sold and reassessed to market value, significantly increasing the tax bill.



**2014: Recovery**

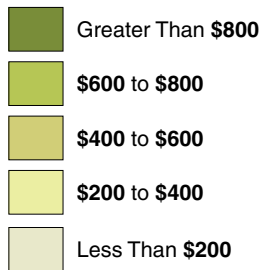
The home's market value recovers and it is again taxed at its inflation-adjusted purchase price.



## NEIGHBORS OFTEN FACE DIFFERENT TAX BURDENS

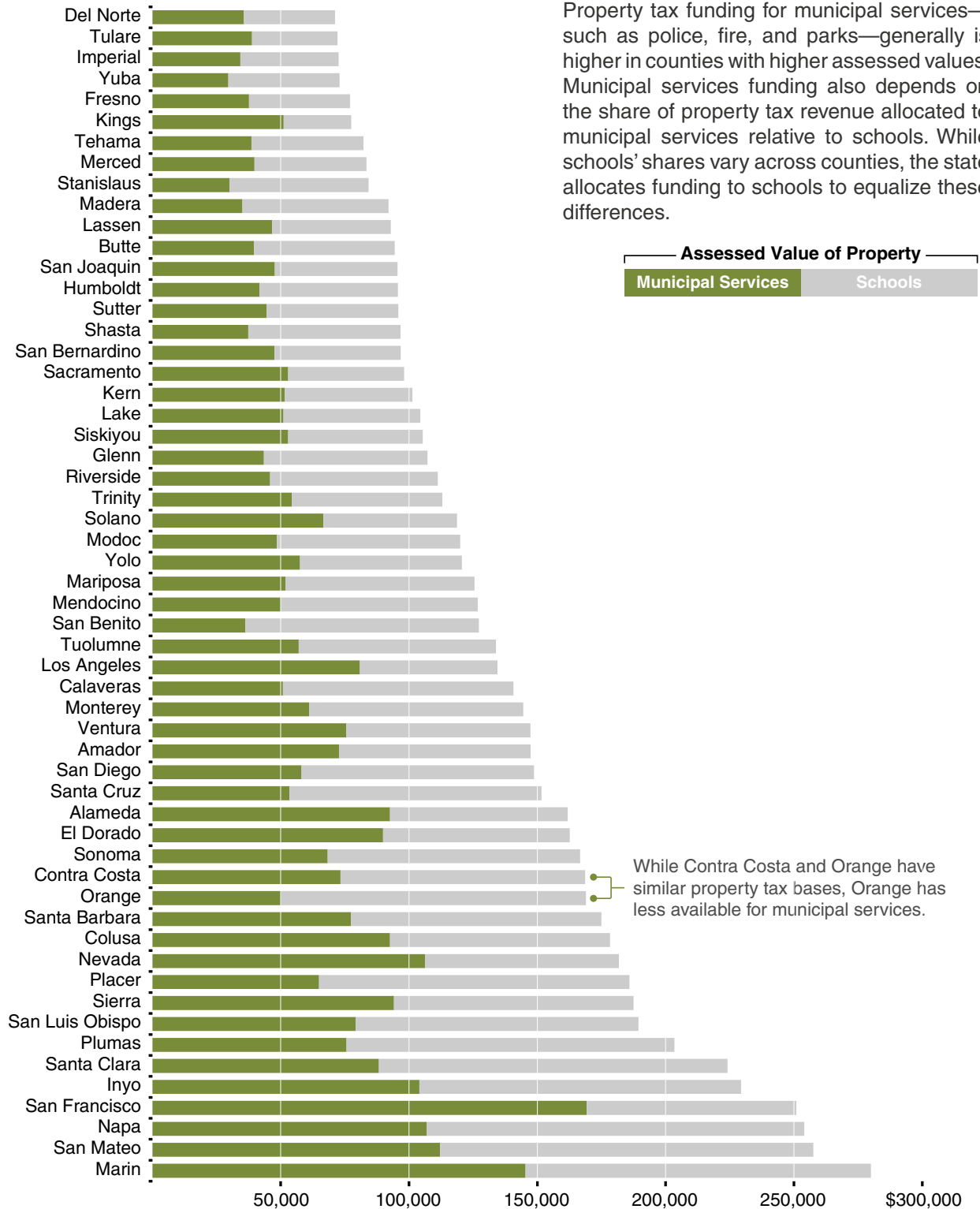
This map shows the property taxes paid per \$100,000 of market value for homes in a Los Angeles zip code in 2015. Property taxes are based on the assessed value, which typically grows more slowly than market value. Because of this, significant differences arise among property owners solely because they purchased their properties at different times.

### Property Taxes Per \$100,000 of Market Value

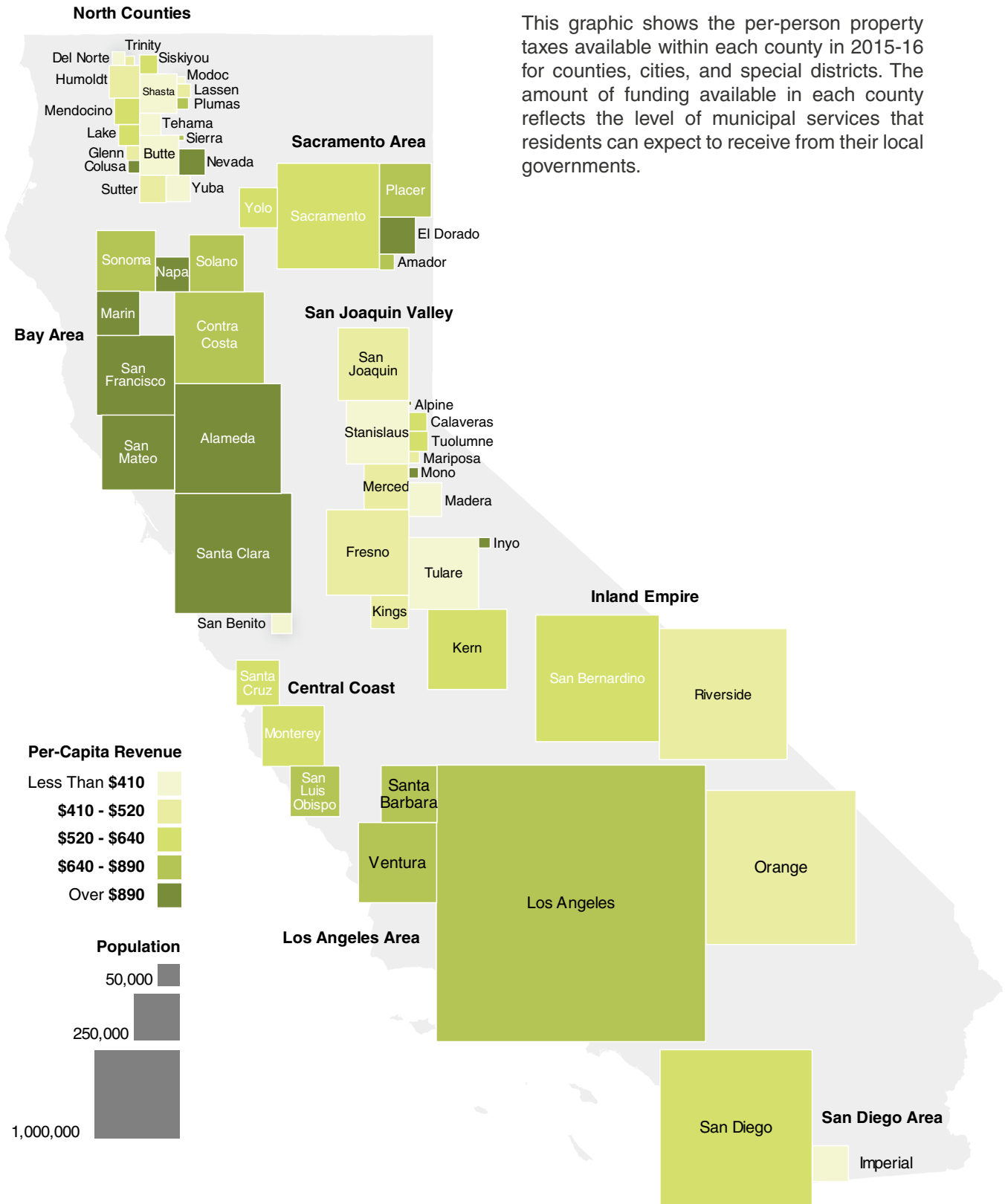


## TWO FACTORS DRIVE FUNDING FOR MUNICIPAL SERVICES

Per Capita Assessed Value, 2016-17



# REVENUE FOR MUNICIPAL SERVICES VARIES WIDELY

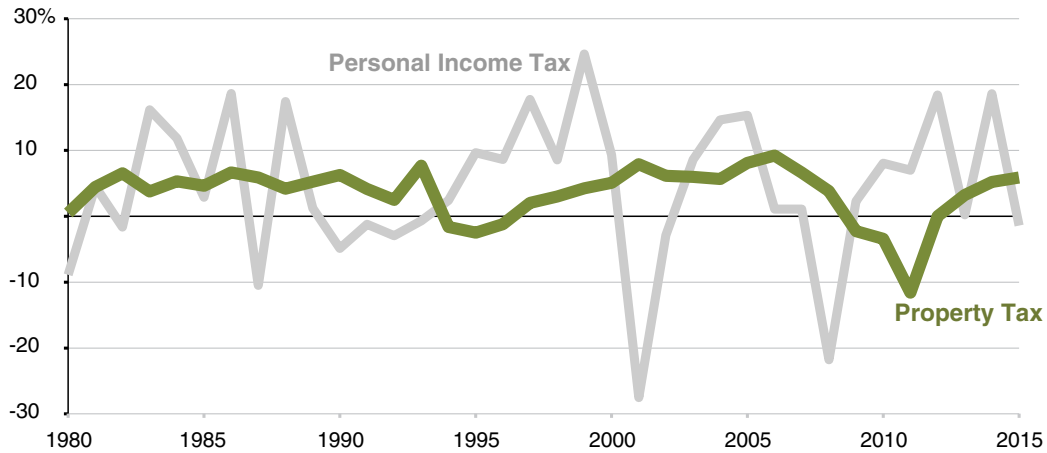


This graphic shows the per-person property taxes available within each county in 2015-16 for counties, cities, and special districts. The amount of funding available in each county reflects the level of municipal services that residents can expect to receive from their local governments.

## PROPERTY TAX MORE STABLE THAN PERSONAL INCOME TAX

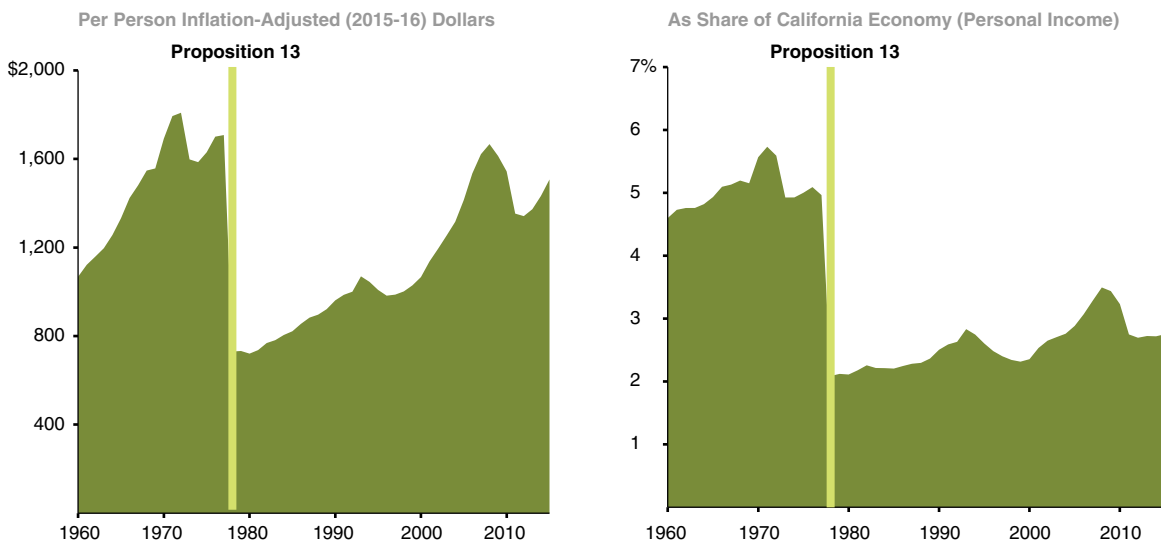
### Annual Percent Change

Stable—or predictable—revenues allow governments to provide consistent levels of service. The property tax—the largest single source of local government revenue—is a stable revenue source compared to the personal income tax, which is the state’s largest single source of revenue.



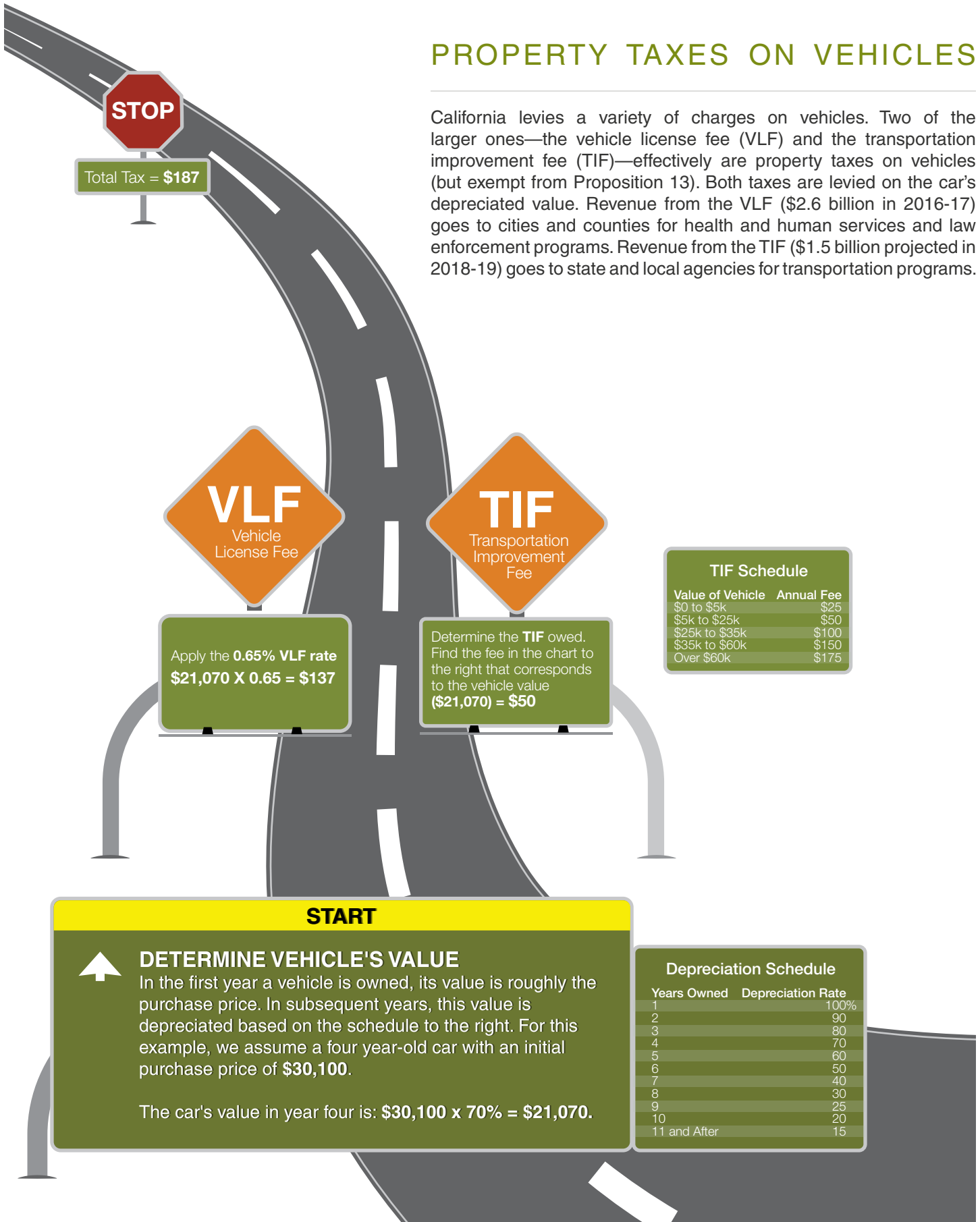
## PROPERTY TAX HAS GROWN SINCE PROPOSITION 13

Governments ideally rely on revenue sources that grow sufficiently to cover any increases in the costs of providing services. Some argue that the property tax has not grown sufficiently to cover local government costs since the passage of Proposition 13 in 1978. Others argue property tax revenues have grown substantially since 1978. Below, we present two ways of measuring property tax revenue growth.



# PROPERTY TAXES ON VEHICLES

California levies a variety of charges on vehicles. Two of the larger ones—the vehicle license fee (VLF) and the transportation improvement fee (TIF)—effectively are property taxes on vehicles (but exempt from Proposition 13). Both taxes are levied on the car's depreciated value. Revenue from the VLF (\$2.6 billion in 2016-17) goes to cities and counties for health and human services and law enforcement programs. Revenue from the TIF (\$1.5 billion projected in 2018-19) goes to state and local agencies for transportation programs.



C H A P T E R

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3



# SALES AND USE TAX

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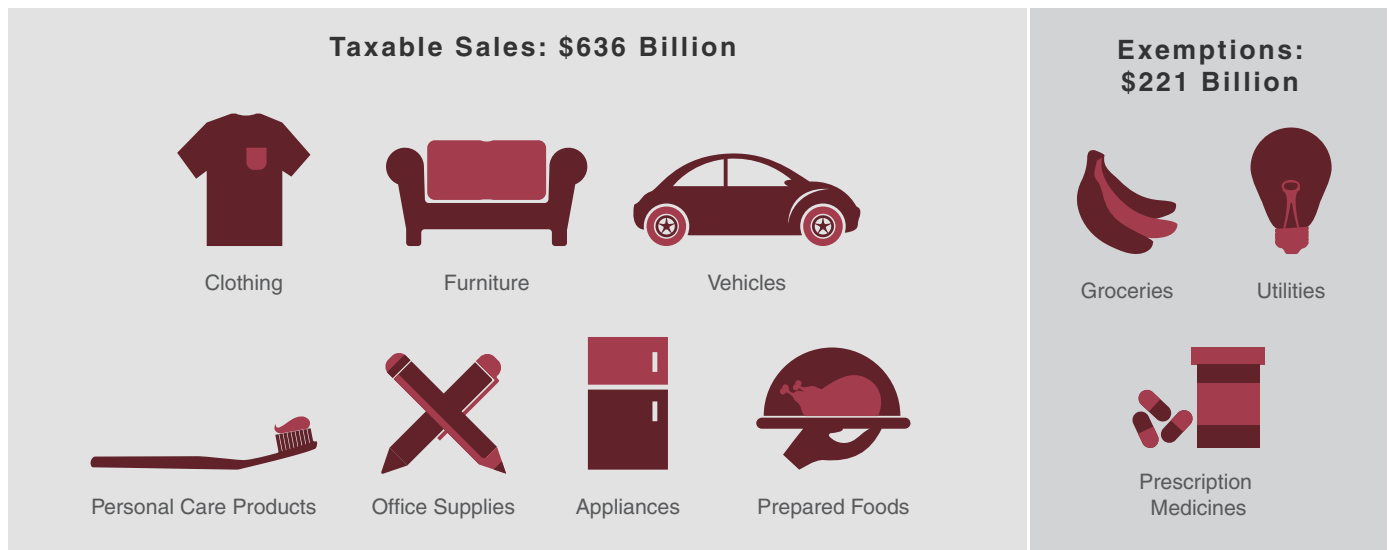
California's state and local governments levy a tax on retail sales of tangible personal property. This tax—called the sales and use tax (hereafter, sales tax)—is a significant source of state and local revenue. In this chapter, we draw distinctions between the products that are subject to this tax and those that are not. We also provide information on the variation in tax rates across the state and the distribution of revenue among state and local programs.

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## WHAT THE SALES TAX IS

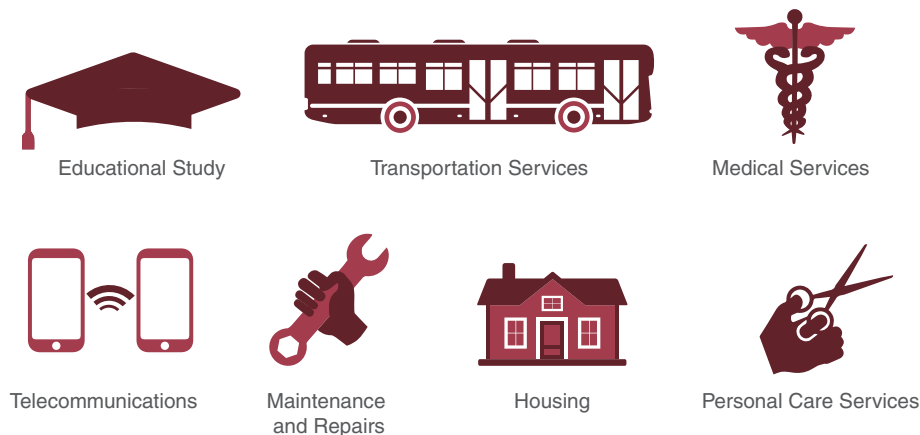
The sales tax is levied on the retail sale of tangible personal property. (“Tangible” refers to physical materials. “Personal property” is movable from one place to another.) The graphic below compares the amount of taxable sales (spending on items subject to the sales tax) in 2015 with the amount of taxable sales that would be subject to the tax if not for exemptions. The icons show major categories of taxable sales and exemptions.



## WHAT THE SALES TAX IS NOT

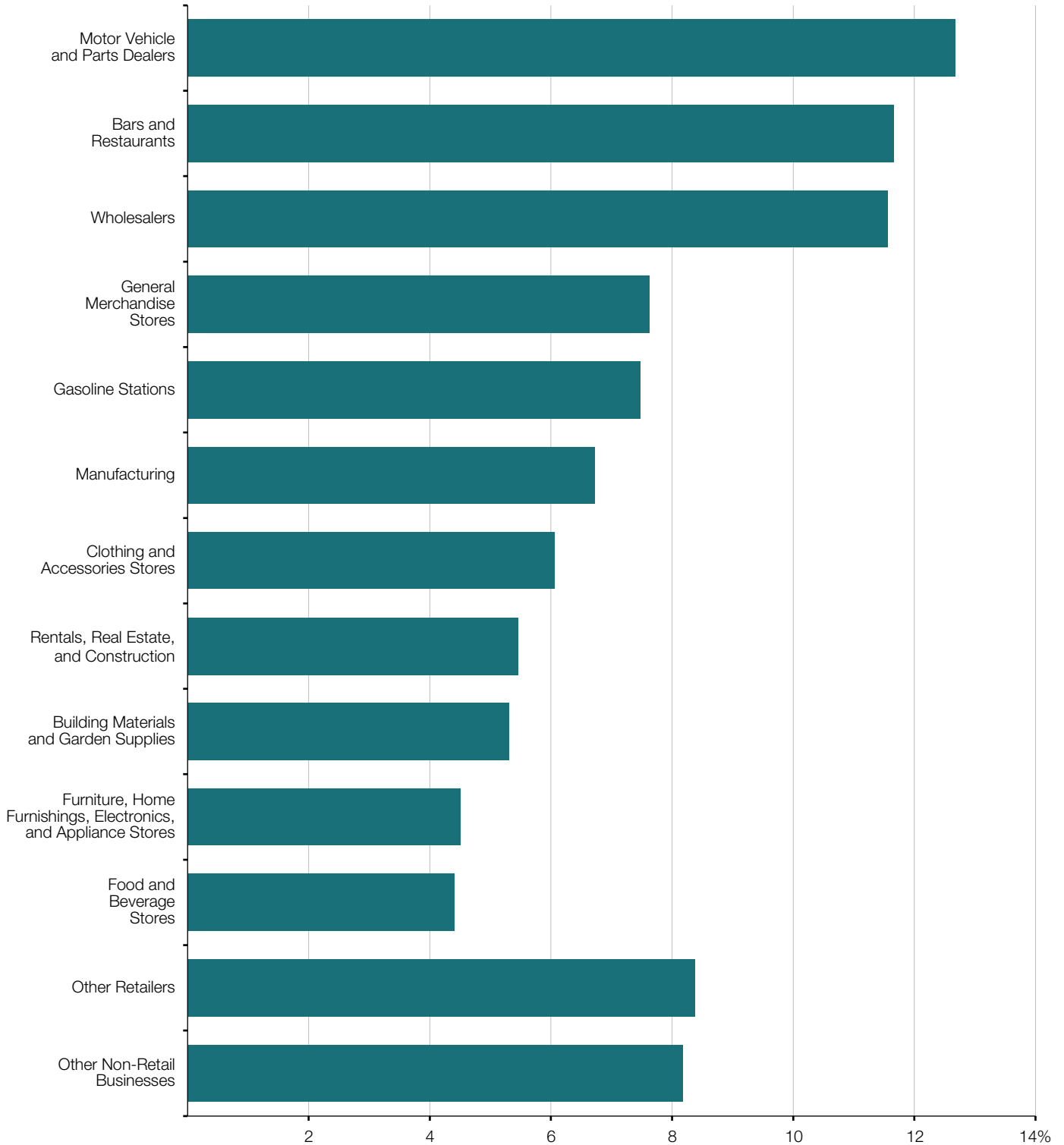
Households and businesses spend money on many services and other items that are not subject to the sales tax, generally because those items are not tangible personal property. Instead, these items are services (such as a hair cut), intangible property (such as an e-book), and real property (such as land). For example, a consumer having their car repaired would pay sales tax on parts like brake pads but would not pay sales tax on the labor associated with the repair. Spending on these items is several times the size of the sales tax base.

### Items Not Subject to Sales Tax



## WHERE IS SALES TAX COLLECTED?

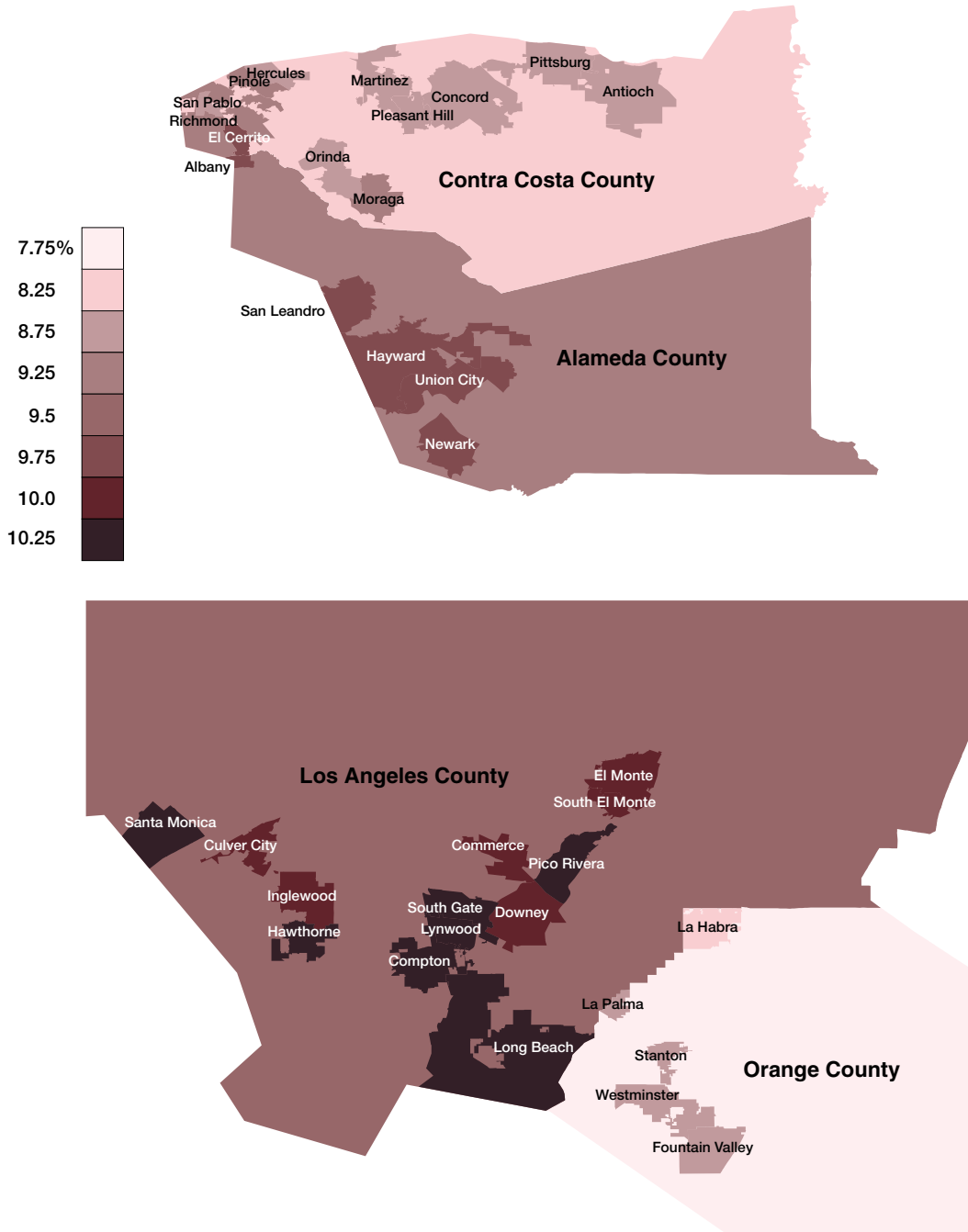
Share of Statewide Taxable Sales by Business Type, 2015



# IN SOME REGIONS, CONSUMERS FACE SEVERAL DIFFERENT RATES

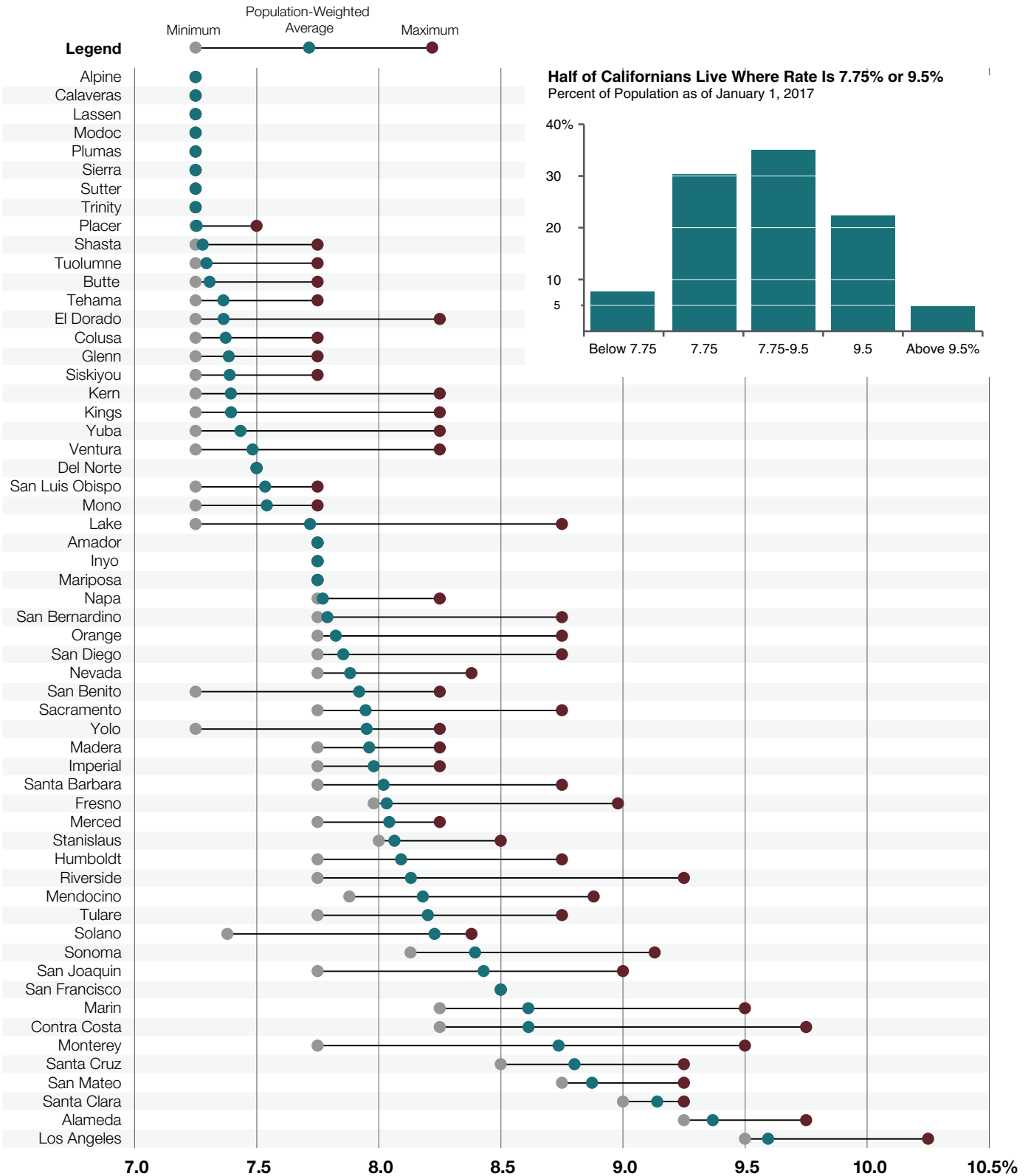
Rates as of April 1, 2018

California's sales tax rates vary across cities and counties, ranging from 7.25 percent to 10.25 percent. These rate differences result from optional sales taxes levied by local governments. (The minimum rate in the two regions shown below is 7.75 percent.)



# SALES TAX RATES IN CALIFORNIA COUNTIES

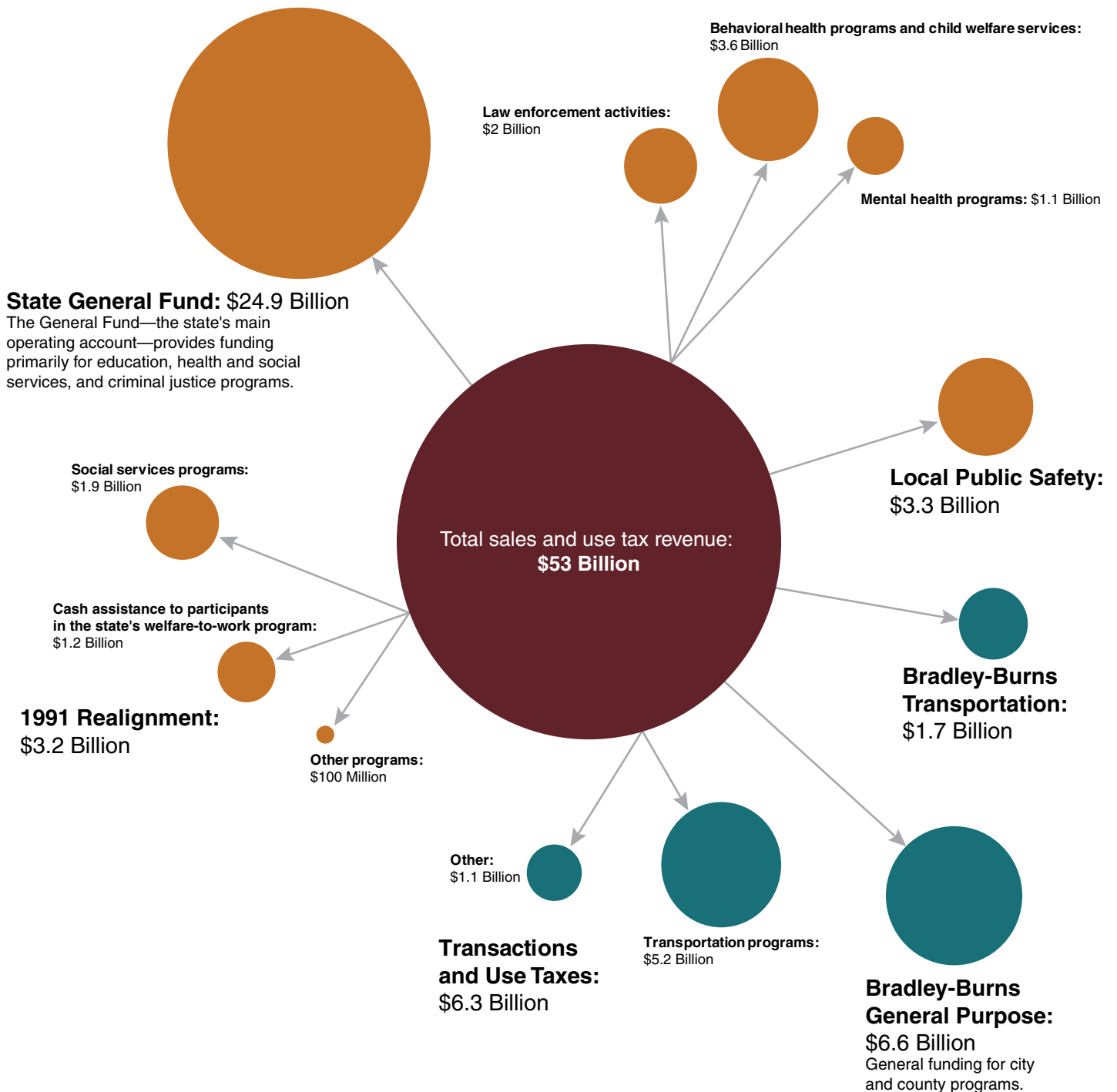
Rates as of April 1, 2018



# DISTRIBUTION OF SALES TAX REVENUE

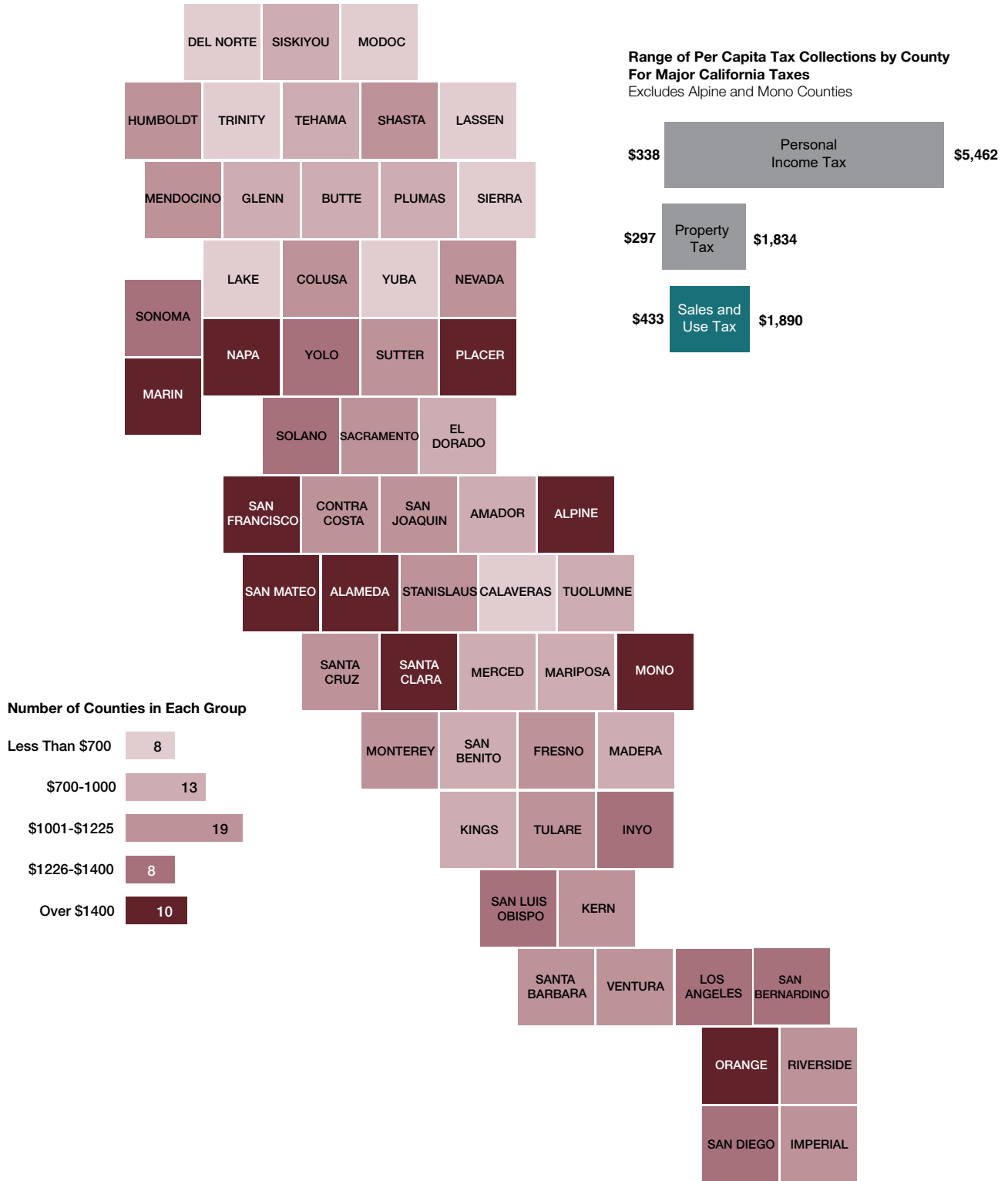
This graphic shows how **sales and use tax revenues** were distributed to the **state**, **state-funded local programs**, and **local governments** in 2016-17.

**2011 Realignment: \$6.7 Billion**



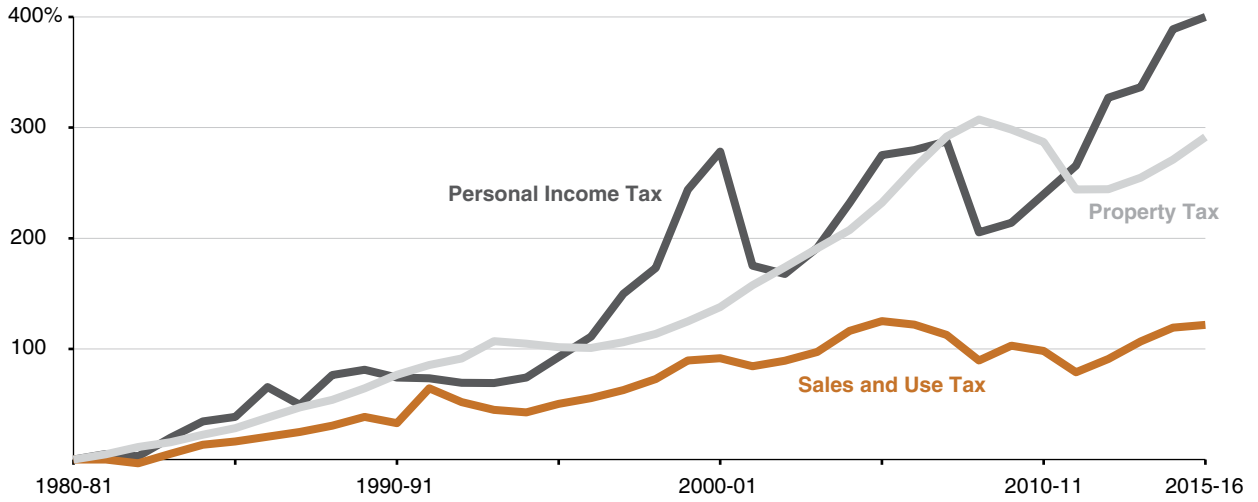
# PER CAPITA SALES TAX COLLECTIONS BY COUNTY

2015-16



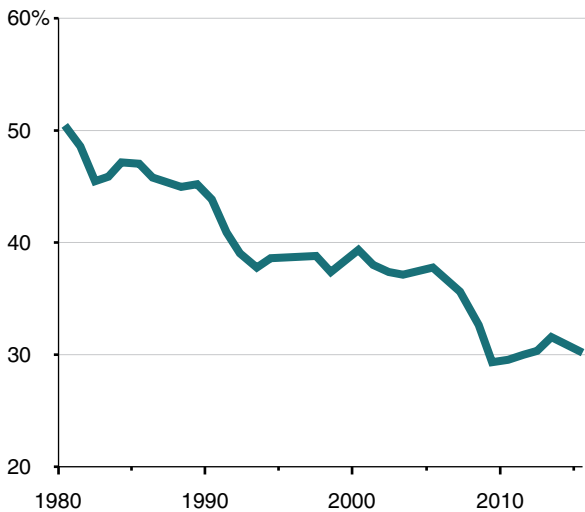
# SALES TAX GROWTH SLOWER THAN PROPERTY AND INCOME TAXES

Total Percent Change, 2015-16 Dollars



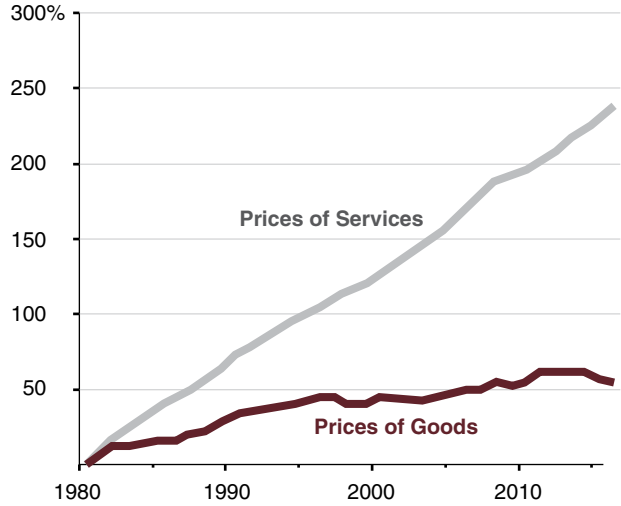
## One Reason: Taxable Sales Have Shrunk as a Share of the Economy...

Taxable Sales as Share of Personal Income



## ...Because Prices of Goods Have Grown More Slowly Than Prices of Services

Total Percent Change





C H A P T E R

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## OTHER TAXES

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Beyond the three main taxes covered earlier in this report, the state and local governments levy a variety of smaller taxes that collectively sum to just over 10 percent of all tax revenue collected in the state. These include taxes on corporations, tobacco, alcohol, diesel and gasoline, insurance, and hotels. (Tobacco, alcohol, and fuels are also subject to the sales tax covered in Chapter 3.)

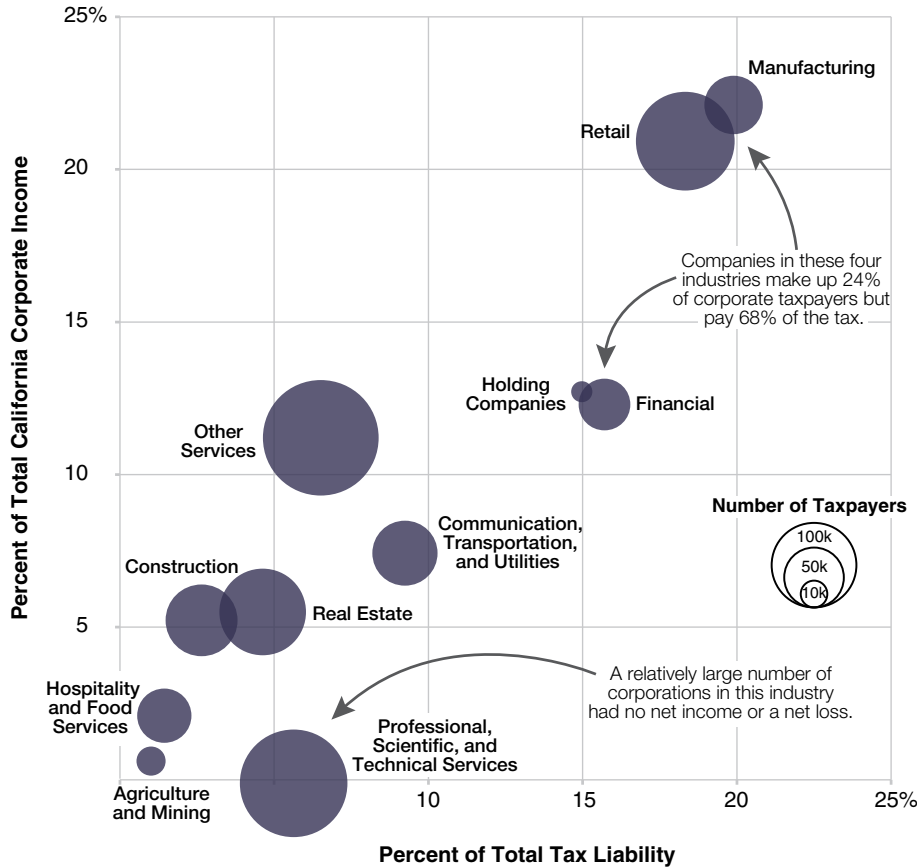
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# WHO PAYS CORPORATION TAX?

2015

California levies a tax on net corporate income. For most corporations, the tax rate is 8.84 percent. California only taxes the portion of income that was earned in California.



## 2 Percent of Corporate Taxpayers Pay 85 Percent of the Tax

Tax Statistics by Income Group, 2015

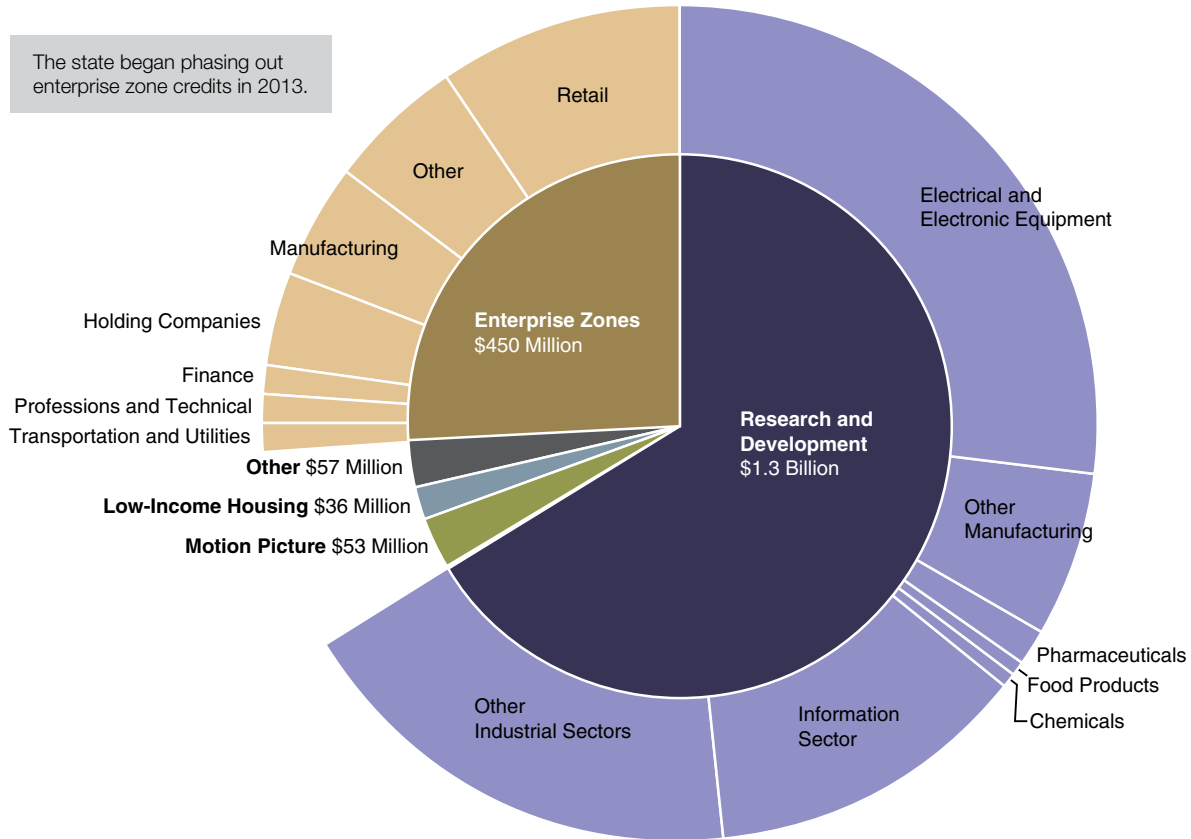
Net corporate income is all revenues less most of the costs of doing business. These deductions may include the cost of raw materials, rent, interest payments, and employee compensation. Many companies have more deductions than their gross revenue, resulting in a net loss.

	Share of Tax Returns	Share of Positive Corporate Income	Share of Tax Liability
No Net Income or Net Loss	40.1%		2.8%
Less Than \$1 Million	57.9%	21.0%	12.4%
\$1 Million to \$10 Million	1.8%	19.7%	13.5%
\$10 Million or More	0.2%	59.3%	71.3%

# CORPORATION TAX CREDITS BY INDUSTRY

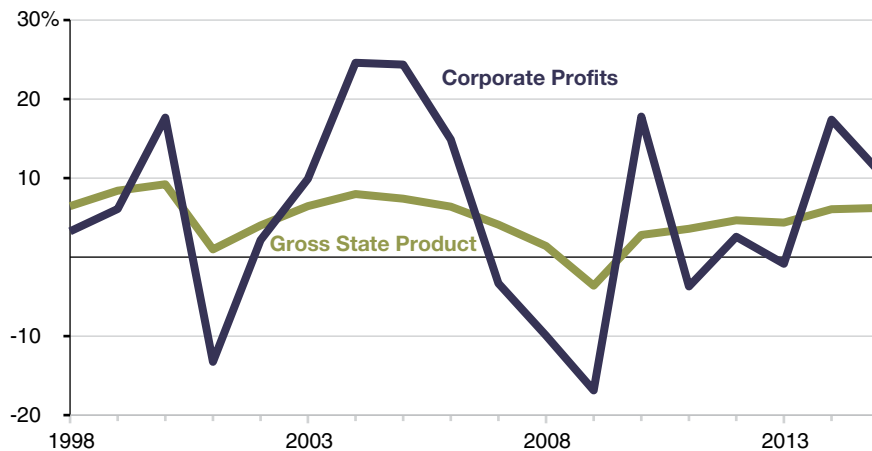
2015

Corporations may apply a credit against their taxes for investing money in ways that further certain policy goals. In the figure below, the darker, inner pie shows a breakdown of credits in 2015. The lighter, outer segments show the distribution of the two largest credits among various types of corporations.



## Corporate Profits More Volatile Than State Economy

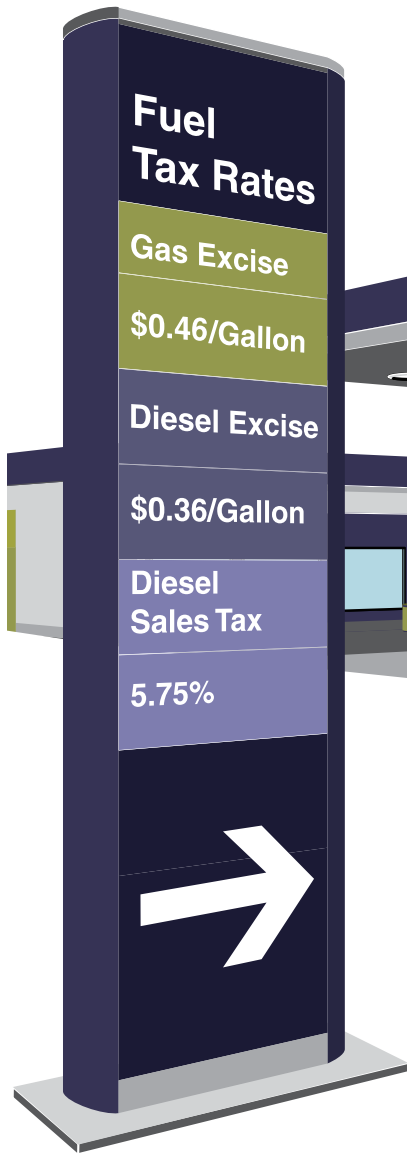
Annual Percent Change



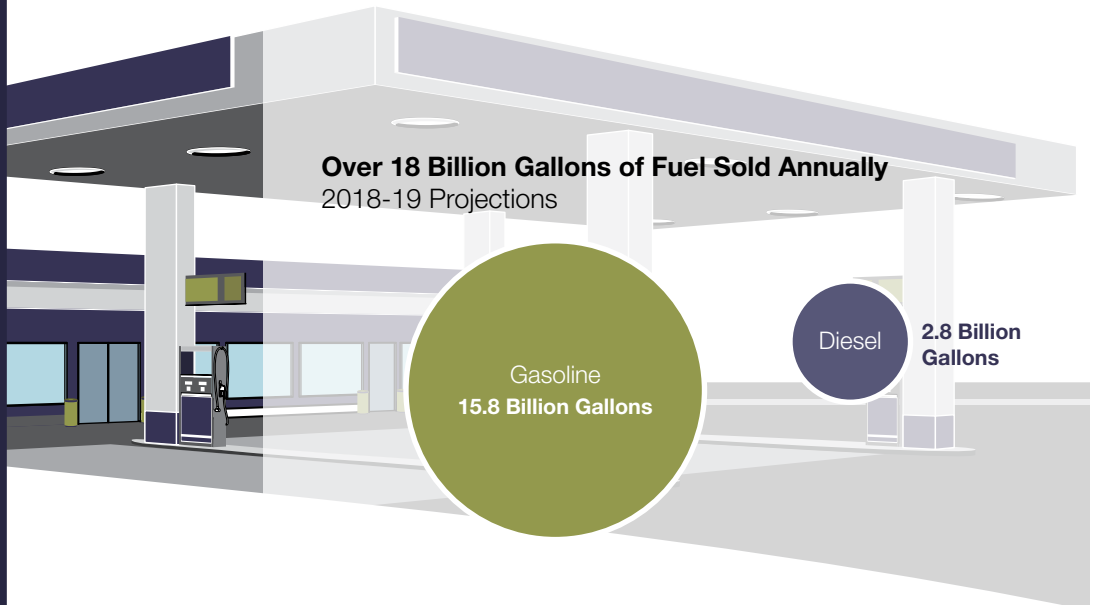
# FUEL TAXES

California levies several taxes that specifically apply to transportation fuel. These taxes include gasoline and diesel excise taxes, which are collected from distributors when they remove the fuel from terminals or refineries. They also include diesel sales taxes, which are collected at the point of retail sale, just like other sales taxes.

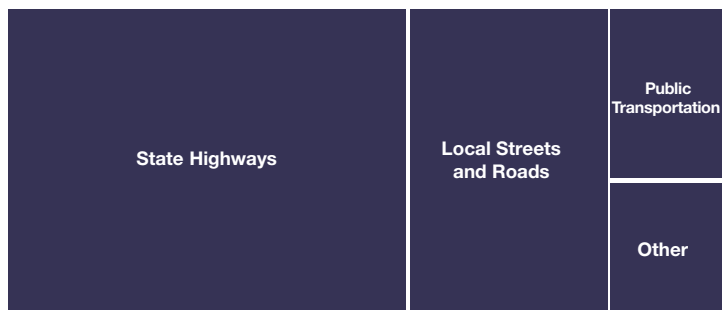
## Fuel Taxes Raise About \$9 Billion Annually 2018-19 Projections



## Over 18 Billion Gallons of Fuel Sold Annually 2018-19 Projections



## Over Half of Fuel Tax Revenues Spent on State Highways 2018-19 Projections

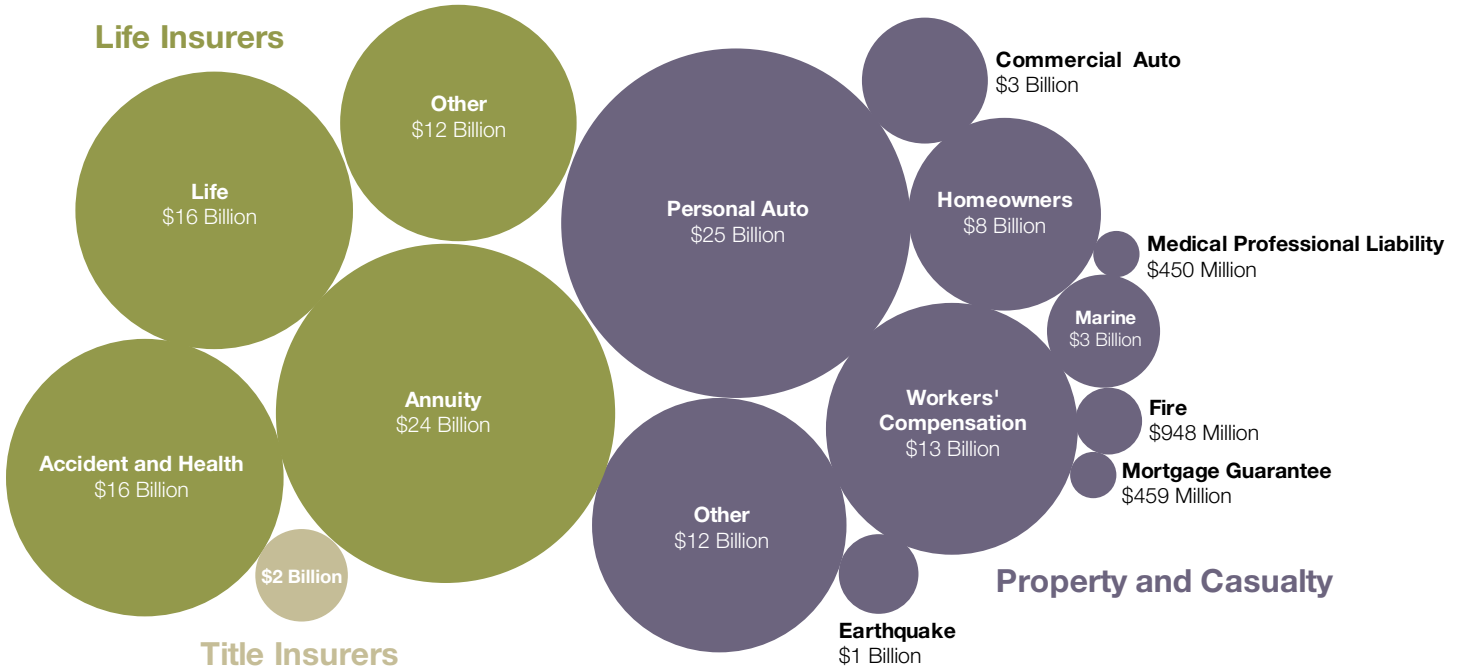


# INSURANCE TAX

The state levies a 2.35 percent tax on insurance premiums. Insurance companies pay the insurance tax instead of the corporate income tax.

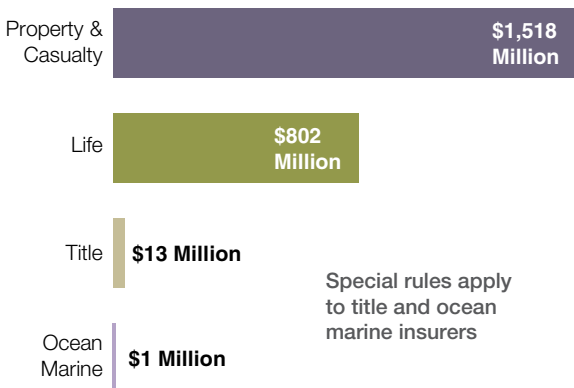
## Insurance Tax Base: \$137 Billion in Premiums

2016



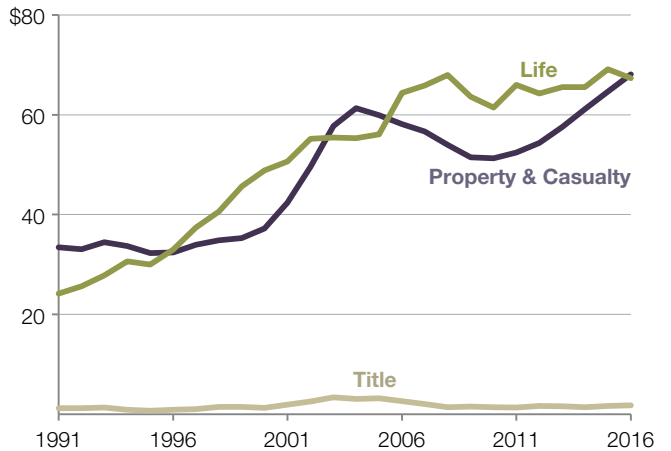
## Insurance Tax Generates \$2.3 Billion

State General Fund, 2016



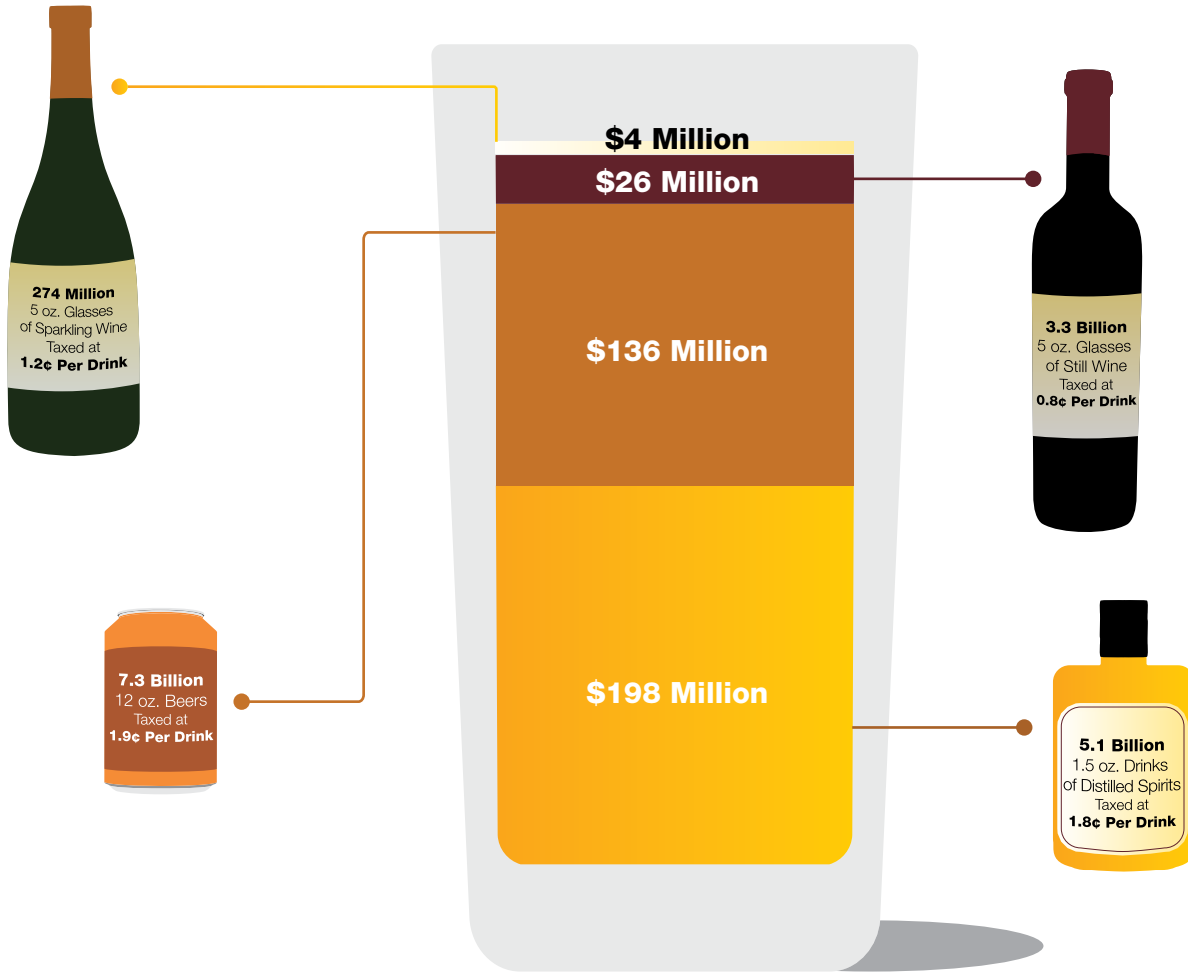
## Trends in Insurance Tax Base

Annual Premiums, In Billions

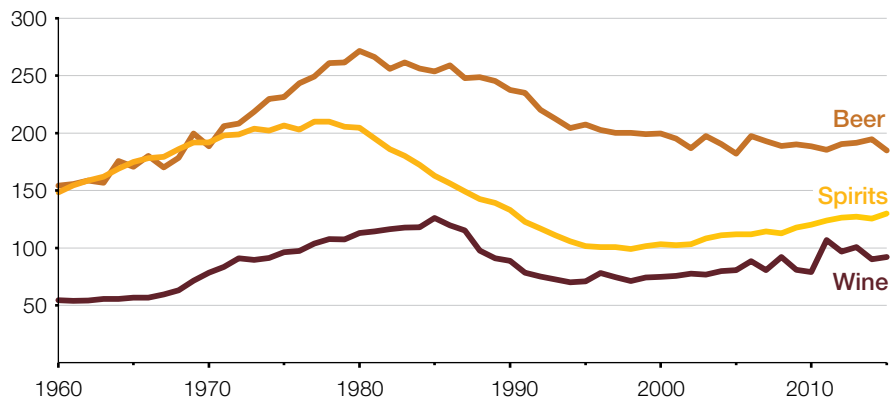


# ALCOHOLIC BEVERAGE TAX

The state levies an excise tax on alcoholic beverages. The tax is levied on distributors (such as wholesalers) based on the volume and type of beverage sold. Revenue from this tax is deposited into the state General Fund, which provides funding primarily for education, health and social services, and criminal justice programs. Revenues from the tax totaled \$363 million in 2015-16.



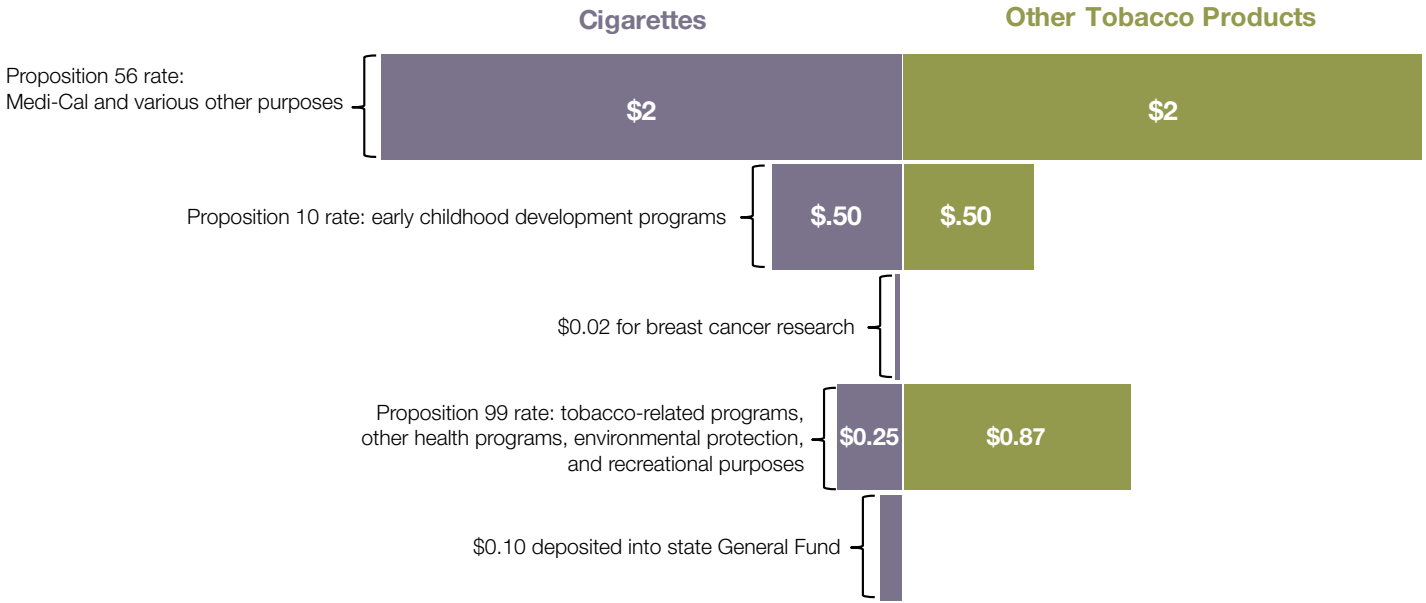
## Alcohol Consumption Trends Annual Drinks Per Capita



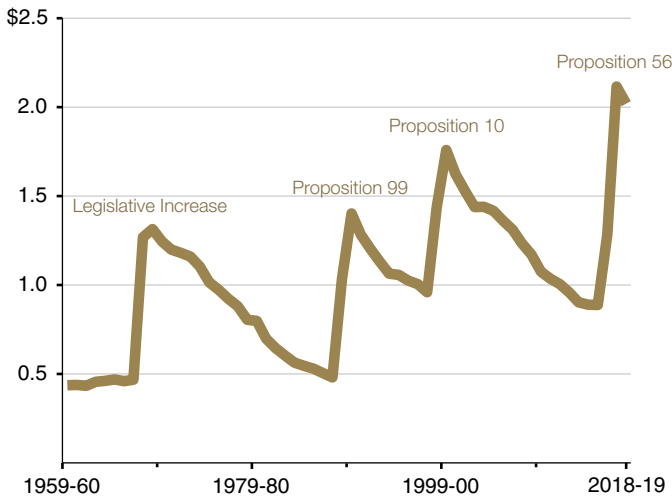
# TOBACCO TAXES

The state levies excise taxes on tobacco products. The taxes are levied on distributors (such as wholesalers). The tobacco tax is levied on cigarettes on a per-cigarette basis. Currently, the tax rate is equivalent to \$2.87 per pack. The tobacco tax on other tobacco products—such as chewing tobacco and electronic cigarettes—is levied as a percent of the wholesale price. The current rate is equivalent to \$3.37 per pack of cigarettes.

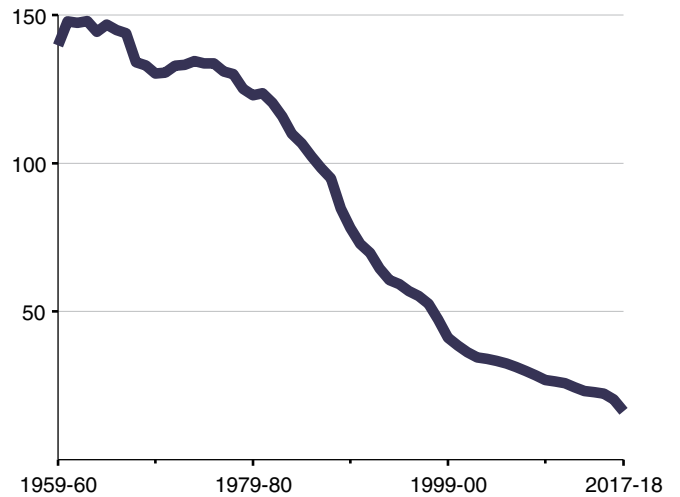
## Breakdown of Tobacco Tax Rates and Spending



**Tobacco Tax Revenues Have Increased Due to Rate Increases**  
2018-19 Dollars, In Billions



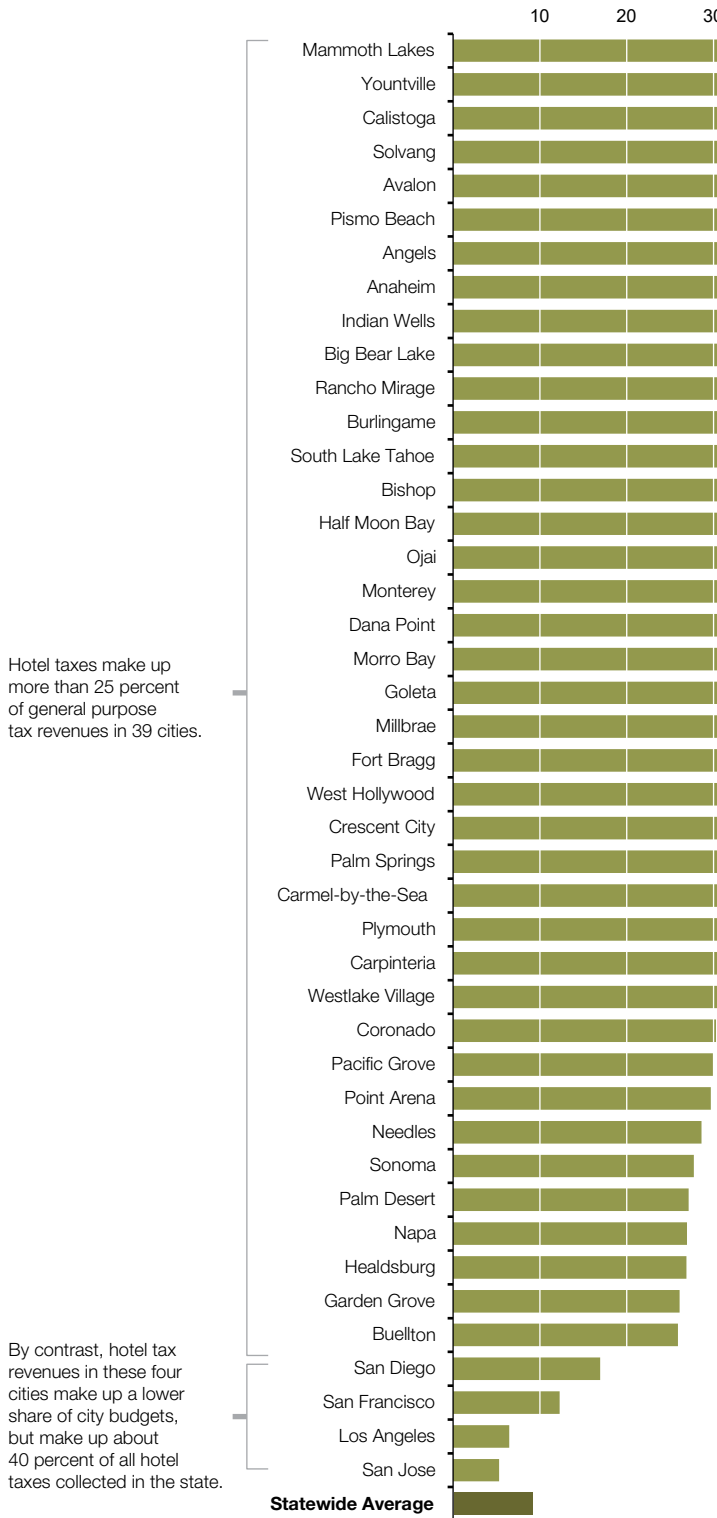
**Annual Per Capita Consumption of Cigarettes Has Decreased Dramatically**  
Packs Per Year



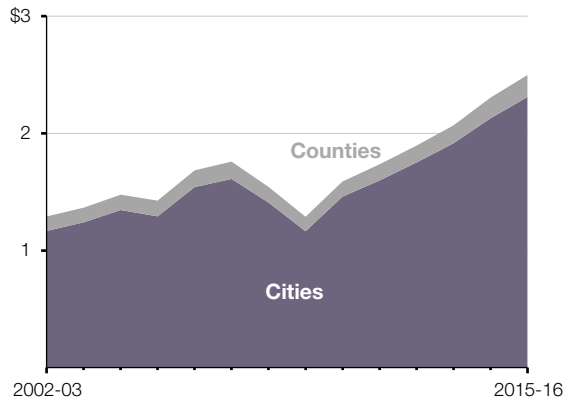
# HOTEL TAXES

## Hotel Taxes as a Share of Total Tax Revenues

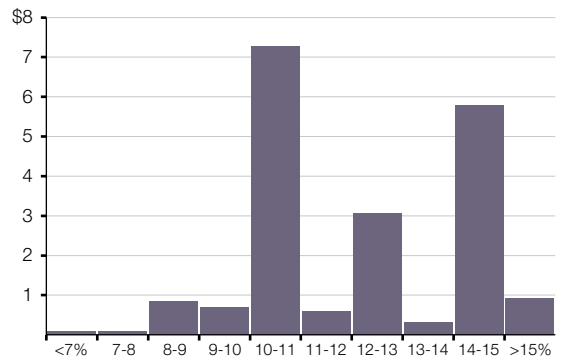
Transient occupancy taxes are imposed on stays at hotels, motels, and similar accommodations. As such, the tax typically is paid by visitors from outside of the city or county in which the tax is levied. While some cities rely heavily on the hotel tax, statewide the tax makes up less than 10 percent of city tax revenues.



**Hotel Tax Revenues Have Doubled Since Great Recession**  
2015-16 Dollars, In Billions



**Most Hotel Spending Is Where Rate is 10% or 14%**  
In Billions, 2015-16



# ADDITIONAL LAO RESOURCES

## GENERAL RESOURCES

LAO Economy & Taxes Blog ([www.lao.ca.gov/LAOEconTax](http://www.lao.ca.gov/LAOEconTax)) and Twitter (@LAOEconTax)

## PERSONAL INCOME TAX

Volatility of the Personal Income Tax Base ([Report](#))

Volatility of California's Personal Income Tax Structure ([Report](#))

## PROPERTY TAX

Understanding California's Property Taxes ([Report](#))

Understanding Your Property Tax Bill ([Blog Series](#))

Calculating Your 1 Percent Tax ([Video](#))

The 1 Percent Tax—Where Does Your Money Go? ([Video](#))

Common Claims About Proposition 13 ([Report](#))

The Property Tax Inheritance Exclusion ([Report](#))

## SALES AND USE TAX

Understanding California's Sales Tax ([Report](#))

Why Have Sales Taxes Grown Slower Than the Economy ([Report](#))

## TAX EXPENDITURES

Review of the California Competes Tax Credit ([Report](#))

California's First Film Tax Credit Program ([Report](#))

Community Development Financial Institution Tax Credit ([Report](#))

Options for Modifying the State Child Care Tax Credit ([Report](#))



## **LAO PUBLICATIONS**

This report was prepared by Ryan Miller and Vu Chu, with assistance from Carolyn Chu, Justin Garosi, Seth Kerstein, Brian Uhler, and Brian Weatherford. The Legislative Analyst's Office (LAO) is a nonpartisan office that provides fiscal and policy information and advice to the Legislature. This report and others, as well as an e-mail subscription service, are available on the LAO's website at [www.lao.ca.gov](http://www.lao.ca.gov).