Business Owners (And Wealthy Nonresidents): California Has Its Crosshairs On Your Back

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Let's be honest. The State of California has an insatiable appetite . . . for your money.

As business owners hold about 70% of wealth, the vast majority of "contributors" to the sought-after tax increase discussed below will be business owners. And, for those readers who are not residents of California but have any assets in California, whether business or personal, you will have an opportunity to "contribute" as well.

In our conversation, we are not going to get into the politics of "what the heck are they doing with the money?" Instead, we are going to stick to the fact that the State of California -- relative to its own gross domestic product -- spends money like a drunken sailor and you have been / will continue to be a primary source of money for its spending growth. (To disambiguate, we will use the proper noun "State" or "State of California" to refer to the government and will use "state" or "California" to refer to the location.)

Some years ago, the Cato Institute released a study on the State's spending relative to California's economy for the 25-year period of 1978 to 2003. (The year 1978 marked the passage of famed Proposition 13, which capped property tax increases but did not limit sales tax or income tax rate increases.) The study found that the State's spending increased by roughly *1% per year more than the economy during the entire period*. Thus, *relative to their incomes*, individuals were paying 25% more income tax.

Statistics from the Governor's Office and the National Association of State Budget Officers reveal that the State's spending is growing at twice the rate of GDP growth over the past 20 years. (Read here.)

Those higher taxes did not go unnoticed. The Manhattan Institute published a study that found, during the same period as the Cato Institute study, higher income families were leaving the state (destined for low-tax jurisdictions) and those population losses were being backfilled by lower income families moving into the state.

Part of those higher taxes came from increases in sales tax. When I was a kid growing up in California in the 1960s, the combined State and local sales tax rate was 4% and then 5%. Now,

according to the State's Legislative Analyst's Office, depending on the specific county, it has roughly doubled.

However, the State's revenues from personal and business income taxes are just about twice those from sales tax. Back when I was a kid, the State's top personal income tax bracket was 7%. Now, it is 13.3%.

Send In The Clowns

About a year ago, two members of the State legislature initiated an attempt to reintroduce an estate tax and add a gift (that the State never had) that roughly mirrors the federal gift and estate tax. That attempt was unsuccessful. But, those little dickens are persistent. The matter is formally on the November 2020 general election ballot. If passed, it will take effect January 1st, 2021. That's a year and a half away.

The rate: 10% on wealth above $3.5 million. (For the purpose of this discussion, we will forget about the smaller rate of the proposed gift and estate tax imposed on estates below $3.5 million.) As you can see, the State's threshold is far lower than the federal threshold. And, unlike the old days, the federal gift and estate tax only provides a deduction for state-level gift and estate tax against the value of one's estate and NOT a credit (one-for-one offset) against the federal tax imposed on one's estate.

Nonresidents Beware

But, wait! I'm not a California resident! If you have any personal assets in California -- such as a vacation home in Palm Springs or Tahoe or on the coast -- you are roped in. If you have any business assets in California, you are roped in.

California will likely apply the gift and estate tax to nonresidents with California-located assets in a manner similar to how it applies income tax to nonresidents with California-sourced income.

Let's say that you are not a resident of California and have $1 million of taxable income of which $100,000 is sourced from California. To determine your California income tax liability, you do not simply look up the tax imposed on $100,000. No. That would be too easy . . . and too little. Instead, you determine the tax imposed on $1 million and take 10% of that -- your $100,000 of California-sourced income being 10% of your total taxable income of $1 million. Doing it that way puts you in a higher California income tax bracket.

Now, let's turn to gift and estate taxes. Let's say that your gross estate is $10.5 million of which $3.5 million is located in California -- whether the assets are personal or business. No federal gift or estate tax. And, at first blush, you would say that your $3.5 million located in California is under the $3.5 million exclusion -- thus, no tax. Wrong.

The State of California will likely say that your gross estate is $10.5 million, which is $7 million above its gift and estate tax threshold of $3.5 million. There is a ratio of two-thirds subject to tax and one-third not subject to tax. That ratio would be applied to your $3.5 million located in California. Thus, two-thirds of your $3.5 million in California -- just shy of $2.4 million -- would be subject to the State's new tax. That's $240,000. The Golden State says "thank you."

Here Is The Big Problem

The State intends to impose a gift tax, which it had not done previously. (While many states impose an estate tax, only one imposes a gift tax.) This means that if you want to implement any sort of planning, it is best ***completed*** on or prior to December 31st, 2020. Understand that planning take time and you need to allow sufficient lead time to implement it. Any transfers associated with your planning that occur on or after January 1st, 2021 will be subject to the State's new gift tax. The clock is ticking. Get to it.