The California Tax on Extreme Wealth (ACA 8 & AB 310): Revenue, Economic, and Constitutional Analysis

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March 23, 2021

The California Tax on Extreme Wealth (ACA 8 & AB 310) imposes an annual tax of 1% on extreme wealth, defined as wealth in excess of $50 million per taxpayer. It also adds graduation with an extra .5% tax rate on wealth above $1 billion. We estimate that about 15,000 CA families (top .07% richest families) would be liable for the tax on extreme wealth and that the tax would raise about $22.3 billion/year (starting in 2023 based on end of year 2022 wealth). About half of the revenue would be raised from the 170 or so billionaires in the state. The wealth tax would increase tax revenue, improve tax justice, and help reduce wealth concentration.

Inequality and tax fairness

California today has 12% of the US population but 17% of all US millionaires and 25% of all US billionaires.[1] In 2011, California had only 15.5% of all US millionaires and 21% of all US billionaires. Therefore, the California share of US millionaires and billionaires has been increasing over the last decade even though California increased its tax on millionaires in 2012.[2] Income and wealth is more concentrated in California than in the US overall and this concentration has been growing faster.[3] The covid crisis further exacerbates inequality: the working class struggles with job and income loss while the rich can generally keep working from home. California billionaires' wealth has already fully bounced back and even surpassed pre-covid levels. The collective wealth of California billionaires has surged to $960 billion on January 24, 2021.[4] It was $706 billion in March 2019, a year before the covid crisis started and only about $300 billion a decade ago in 2011.[5]

While the income tax is successful at taxing most Californians, it is not very effective at taxing the ultra-wealthy who do not need to realize their incomes.[6] For example, Mark Zuckerberg, Sergey Brin, or Larry Page, the richest Californians, can avoid the CA income tax as long as they

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[1] The CA and US populations are 39.5m and 331.8m in 2019. The IRS compiles individual income tax statistics by state. In 2016, 2017, 2018 the last 3 years available, CA millionaires were 16.8%, 16.7%, and 16.9% of all US millionaires. As of January 24, 2021, there were 163 CA billionaires out of 663 US billionaires (24.6%) on the Forbes billionaire list.
[2] The CA share of the US population has been stable during this decade from 12.08% in 2011 to 12.04% in 2019.
[3] The top 1% income share is higher in CA than US wide in recent years (e.g., 25.5% vs. 22% in 2015) but was the same in the 1980s (e.g., 9.9% vs. 10.0% in 1980). See https://www.shsu.edu/eco_mwf/inequality.html
[4] This excludes Elon Musk who is now listed as a Texas resident.
[5] See the Forbes billionaire list.
[6] Saez and Zucman (2019), *The Triumph of Injustice*, Norton estimate that the effective tax rate on billionaires (combining all taxes at the federal, state, and local levels) relative to their true economic income is only 23% in 2018 (while it is 28% economy wide).

do not sell their Facebook or Google stocks. This is the main weakness of the CA tax system. The wealth tax directly remedies this injustice by taxing all wealth, whether this wealth has been realized as income or not. With the wealth tax, billionaires would have to pay between 1% and 1.5% of their wealth in wealth taxes even if they do not sell their assets just like homeowners have had to pay annual property taxes based on the value of their homes.

The wealth tax would in the long run help reduce wealth concentration. For example, after 10 years of tax at 1%, the wealth of a billionaire would be reduced by about 10% (as compared to what it would be absent the wealth tax). This is not radical, megamillionaires and billionaires typically earn returns on their asset values many-times larger than the wealth tax rates, but this would still be a valuable step toward reducing excessive wealth concentrations and would bring much needed extra tax revenues for the state of California. (Notably, the rates in Senator Elizabeth Warren's federal wealth tax bill (February 2021) are double those of the proposed CA tax).

Revenue analysis

We estimate that the tax on extreme wealth would generate $22.3 billion in additional revenue per year for the State of California in 2023 (based on end of year 2022 wealth). The tax would subsequently grow with the size of the economy each year afterwards. About 15,000 CA families (top .07% richest families) would be liable for the tax. The 170 or so California billionaires would pay $10.6 billion almost half of the total revenue. The table attached at the end shows more details on these estimates.

These revenue estimates are made using Californians on the Forbes real time billionaire list combined with the US wide Survey of Consumer Finances (and assuming that 17.5% of wealthy Americans reside in California, consistent with IRS tax data on CA millionaires). We have also assumed a tax evasion rate of 20%. There will be always be some non-compliance due to under-reporting, under-valuation of assets, etc. A 20% evasion rate is realistic given the strong enforcement measures included in the proposal. This is slightly higher than the 15% evasion rate for income and corporate taxes (as estimated by the IRS).

Economic impacts

Will ultra-wealthy CA residents leave the state?

As mentioned above, the California share of all US millionaires and billionaires has increased over the last decade in spite of the 2012 high income surtax. Therefore, we are still far from a tipping point. Empirical work has shown that state income taxes do generate some mobility in the millionaire class but these effects are small as most millionaires are tied to their state through multiple social and economic networks. Millionaires actually have lower migration rates than the general population.[7]

The wealth tax bill is also structured in such a way that CA wealthy residents who leave still have to pay the tax on extreme wealth on a fraction of their wealth for up to 4 years: they pay tax on 75% of their wealth the year after they leave, on 50% 2 years after they've left, 25% 3 years

[7] See Young, Cristobal, Charles Varner, Ithai Z. Lurie, and Richard Prisinzano. "Millionaire migration and taxation of the elite: Evidence from administrative data." *American Sociological Review* 81, no. 3 (2016): 421-446.

after they've left, and 0% only 4 years or more after they've left. For example, Elon Musk built his wealth in California ($183 billion as of 1/24/2021), but assuming he becomes a Texas resident in 2021, he would pay the CA wealth tax on 75% of his wealth in 2021, 50% in 2022, 25% in 2023 and zero afterwards (ignoring any possible partial years for simplicity).

The logic is that wealth is the fortune you build over a lifetime and hence a wealth tax requires looking beyond the current year. This makes the wealth tax harder to avoid than the income tax (where you are no longer liable after leaving the state).

Will ultra-wealthy be deterred from coming?

Symmetrically, the wealth tax kicks in progressively for new residents. They are exempt from the tax on their first year of residence. They pay the tax on 25% of their wealth in their second year, on 50% in their third year, 75% in their fourth year, and on 100% only after 5 years. Therefore, the wealth tax is initially modest for wealthy newcomers who built their fortune outside of California.

Will entrepreneurs be discouraged?

The wealth tax allows entrepreneurs whose wealth is tied up in a private business (e.g., a very successful start-up whose stock does not trade publicly yet) to defer payment so that the wealth tax does not interfere with business decisions. The deferred payment is set up to be paid upon stock sale or issuance or upon the payment of dividends of the equivalent. For example, an entrepreneur who sells her start-up for $1 billion after having deferred the wealth tax for 5 years would owe approximately a 5% wealth tax on her sale (5 times 1%).

Won't the wealthy be able to hide their wealth and evade the tax?

The bill includes a number of strong provisions to make evasion quite difficult. The wealth tax base is comprehensive with no exclusions.[8] Taxable wealth includes worldwide assets. Therefore, CA residents cannot avoid the wealth tax by moving their assets outside of California (except for the relatively limited exception of directly owned personal property such as cars, artwork, or collectible which represent only about 3% of the wealth of the ultra-wealth based on estate tax data[9]). Owning wealth indirectly through trusts or corporate shells will not generally reduce valuations for wealth tax purposes. Offshore financial wealth is already reported to the IRS by both owners and foreign institutions. Subsequent sales of assets at prices higher than previously reported will generate ex-post adjustments. There are penalties for under-reporting wealth.

Increasing taxes during a recession?

Higher taxes depress the economy in the short-term if they reduce spending. But the rich are now piling up income they cannot spend (as the crisis limits spending opportunities).

[8] Real estate property directly held is excluded but this already pays a property tax that is sometimes higher than the tax rate on extreme wealth rate of 1% or 1.5% (especially for recently bought property). Directly held personal property located out of state is also excluded, but this is not a large component of the wealth of megamillionaires or billionaires.

[9] US Treasury, Office of Tax Analysis, 2014. "Tax Expenditure for Exclusion of Capital Gains at Death."

Therefore, an extra tax would not cut their spending. Lower government spending however would for sure negatively affect the economy. Borrowing from the rich or taxing the rich is imperative to fight the recession. Unfortunately, states cannot borrow through public debt and the federal government (which can borrow at almost zero interest rate) may not help the states as much as needed. If California cannot borrow nor receive federal support, then taxing the rich to preserve essential public spending is the best option to limit the economic damage of the crisis.

Comparison with AB2088

The current proposal ACA8 & AB310 is more ambitious bill AB2088.

AB2088 proposed a smaller .4% tax rate above a smaller exemption of $30 million. As a result, AB2088 would have taxed more families (30,000 instead of 15,000) but would have raised considerably less revenue ($7.5 billion/year instead of $22.3 billion/year). See our previous discussion of AB2088.

The new proposal includes a constitutional amendment (ACA8) that allows taxing extreme wealth at a rate higher than .4% (the current constitutional limit). The new proposal also offers a much more detailed enforcement framework to minimize tax avoidance opportunities and the regulatory burden on the Franchise Tax Board.

Constitutionality Issues

The tax on extreme wealth was carefully designed to stay clear of constitutional issues. Here are the most often asked questions on this:

Does the state constitution of California allow for taxing worldwide wealth of CA residents?

Yes. In the same way the CA income tax applies to CA residents on their worldwide income, the CA wealth tax can, with exceptions the bill respects, apply tax on worldwide assets.

Does the tax on extreme wealth affect Proposition 13 tax limitations?

No. The wealth tax excludes real estate property directly held from taxation.

Does the federal constitution allow states to tax wealth?

Yes, states have wide latitude to set their tax systems so long as, speaking generally, there is not double taxation. Accordingly, the wealth tax provides credits for any similar wealth taxes levied on taxpayers by other jurisdictions.

Why is this a constitutional amendment?

The California constitution currently limits the tax rate on net worth to .4%. Therefore, it is not possible to go beyond .4% without amending the constitution. This is why the new proposal includes a constitutional amendment (ACA 8) that overcomes the current .4% constitutional limit. If the proposal is approved by the legislature, it would still require approval by a simple majority of voters in the 2022 election to be enacted. If the proposal is not approved by the legislature, it could still be enacted through a ballot initiative if it receives enough signatures to make it on the ballot and then a simple majority of votes in the 2022 election.

Revenue estimates from the California Tax on Extreme Wealth (in 2022 $)

Tax Bracket	Tax rate in bracket	Tax base in $billions	Number of taxpayers	Share of CA families liable	Tax revenue in $billions (per year)
$50 million to $1 billion	1.0%	1177	14,396	0.065%	11.8
$1 billion and above	1.5%	704	172	0.0008%	10.6
Total (summing the two brackets):		1880	14,568	0.065%	**22.3**

Notes: The table displays revenue estimates for the California tax on extreme wealth. This is an annual tax on the total worldwide net worth of California residents starting in 2023 (based on end of year 2022 wealth). The exemption threshold of $50 million is the same for married and non-married taxpayers. The wealth tax combines a tax of 1% on wealth above $50 million with an extra .5% tax above $1 billion (so that the total marginal tax rate above $1 billion is 1.5%). Estimates are based on the 2019 Survey of Consumer Finances (aged to 2022) combined with the Forbes billionaires list (as of January 24, 2021 and aged to end of 2022). We assume a 20% tax avoidance/evasion rate which is realistic given the robust proposed enforcement.

The California Tax on Extreme Wealth (ACA 8 & AB 310): Detailed Plain-English Summary Outline

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March 23, 2021

Overview

The proposal would impose a 1% tax on extreme wealth, defined as all wealth in excess of $50 million per household, with this rate rising to 1.5% on wealth in excess of a billion dollars. Thus, a household worth $51 million would pay a tax of $10,000 annually. Real estate property that is owned directly by the taxpayer is exempt regardless of where it is located, and personal property that is owned directly by the taxpayer that is located out of state is also exempt.

Many taxpayers are already familiar with a form of wealth tax - the property tax. The extreme wealth tax is, in essence, a property tax on extreme wealth not reached by the traditional property tax. The collection of the extreme wealth tax also resembles that of the property tax. Much of the wealth of the extremely wealthy consists of publicly traded securities. Naturally, wealthy taxpayers already keep track of the value of their public investments and so, as to this kind of wealth, the primary administrative burden imposed by this tax is that a taxpayer provide an account of the value of their publicly traded investments at the end of the year to their accountant.

There are some sources of wealth, such as the shares of a private business, which are harder to value. Yet such valuations are done all the time in the private sector as businesses - or shares in businesses - are bought and sold. In order to pay tax on this kind of wealth, the primary obligation of the taxpayer is to secure such a valuation. Once there is such a valuation, there will usually be no need for further valuations. Rather, the value will be increased formulaically, just like with property taxes. If a major change occurs, there would need to be a revaluation, just like how real property is re-assessed under the property tax when the property is improved.

For particularly hard to value properties or for taxpayers with limited liquidity because of the nature of their wealth, the bill creates a limited deferral mechanism. This structure has analogues in the current administration of the property tax, where states often allow certain taxpayers, particularly the elderly, to defer tax payments. This structure also has analogues to arrangements in the private sector, where the parties enter into payment arrangements that are flexible when the assets being purchased are hard to value.

I. Tax rate

The bill imposes a 1% annual tax on wealth in excess of $50 million per household, or $25 million per person for married individuals filing separately. This rate rises to 1.5% on wealth in excess of a billion dollars, or in excess of $500 million per person for married individuals filing separately. Unlike an income tax, no credit is given for "basis," or the cost of acquiring assets. Thus, as with a local property tax, the same assets may be taxed repeatedly even if they do not change in value.

II. Definition of taxpayer

The tax is imposed only on California residents. Residency is generally defined the same as under the California income tax. Part-year residents, a category under current law, are taxed only on a percentage of their wealth, equal to the percentage of their time spent in California over the course of one year. This category usually applies to taxpayers moving to or from California.

The bill also adds a new category of "temporary resident." These are individuals who spend more than 60 days in a year and either 120 days over the last two years or 150 days over the last four years in California. They are also taxed only on a proportionate share of their wealth.

Great wealth is accumulated over time. Accordingly, individuals whose residency status changes over time are "phased" in and out of full residency or, put another way, phased in and out of paying tax on all of their wealth. As with part-year residents, a taxpayer is taxed only on the share of their wealth equal to the portion of the last four years they have been a resident. New Californians do not have to count their first year as a residence year. Individuals who leave California are still taxed under these same rules. For example, an individual who left California at the beginning of this year after residing there for a decade would be taxed on 75% of their wealth (three of past four years as California resident) in that first year after leaving, reducing to 50% in the second year, and so on. Taxpayers can use an alternative allocation method if they can show by clear and convincing evidence that these rules unfairly apportion their wealth to California.

An individual's wealth includes wealth held by minor children. The bill adopts standard federal tax law definitions of related parties, as those rules stood at the end of 2020.

III. What is taxable

In general, the tax is imposed on anything of value. For both California and federal constitutional reasons, real estate is exempted, unless held through a trust or business entity. For federal constitutional reasons, personal property--such as cars and jewelry--that is located out of state is also exempted, unless held through a trust or business entity. Payments in exchange for future services are also effectively exempt until those services are actually performed.

The bill also includes a provision akin to federal gift tax rules, intended to prevent related taxpayers from dividing up their wealth to claim the $50 million exemption repeatedly. Under this provision, a taxpayer's worldwide wealth includes any asset they have transferred to a related party, or otherwise to another party under circumstances in which the transferor remains in control of or directly benefits from the transferee's use of the transferred asset (and a grant of an asset to a charitable organization subject to conditions imposed by donor will not ordinarily constitute "control" so long as the conditions do not allow the use of the asset to inure to the private benefit of the donor). The transferor may reduce this included amount by the fair market value of any consideration (other than services) paid to the transferor by the transferee. In the case in which consideration includes assumption of a liability of transferor, the amount of consideration credited cannot exceed the amount by which such liability would have reduced the worldwide wealth of transferor. For purposes of this provision, any trust which includes as a potential beneficiary a related person to the taxpayer is itself a related person. Any asset that would be taxed more than once under this rule is instead assigned to the taxpayer in whose hands the asset would result in the greatest amount of tax.

We note that nothing in this related-party rule prevents dynastic planning in which an older generation divides its wealth among multiple heirs in such a way as to maximize the number of $50 million exemptions available once the older generation is deceased. Since, however, the result is to encourage dynasties to break wealth into many smaller pieces, we view this result as consistent with the general goals of the bill.

IV. Valuation Rules

Publicly traded assets are valued on the last day of each tax year. For businesses conducted other than through a business entity, the owner is taxed directly on the (net) assets of the business.

A. Business valuation

Privately held businesses can be valued according to several different methods, depending on available information and taxpayer elections. As a basic starting point, the value of any business enterprise (other than publicly-traded businesses) is determined under a system similar to that used in the Swiss wealth tax, where the business value is presumed to be the GAAP book value of its assets, plus 7.5 times its GAAP annual profits for the most recent business year.

For businesses of less than $50 million in value under this base method, taxpayers may, and for all other businesses taxpayers must, also submit a qualified appraisal, as detailed below. If a taxpayer shows by clear and convincing evidence that the base method overvalues the business, the taxpayer can use the appraisal instead. If the appraisal is higher than the base method, the appraisal value controls.

Valuation also must be updated with information from market transactions that indicate the value of the business, such as arms-length sales of a full or partial equity interest. If there has been such a transaction within the past ten years, the business must be valued at no less than the value implied by this transaction, increased by a market rate of return determined by the California Franchise Tax Board (with appropriate adjustments for contributions to or withdrawals from the business).

Similarly, if a transaction that indicates the value of the business occurs within four years after the filing of a wealth tax return for a given year, taxpayers must revisit their earlier valuations. Value in a past year is presumed to be no less than value as indicated in the later transaction, deflated by FTB's market rate of return (and adjusted for any contributions to or withdrawals from the business). Taxpayers must remit additional tax in the event that a subsequent transaction shows that earlier valuations were too low, unless they can show by clear and convincing evidence that the retrospective valuation overstates the earlier-year value.

At a taxpayer's election, illiquid and hard-to-value business interests can be taxed under special rules described more below.

B. Business ownership

A taxpayer is taxed only on the fraction of a business' value equal to the share of the business they own. Typically, that fraction will be at least the taxpayer's share of the vote or other control rights in the business. Meaningful interests in businesses in excess of the share represented by control rights, such as non-voting preferred stock, must be separately valued by appraisal. Claims on firm assets that represent payment for future services, such as unvested performance-based restricted stock, are not included.

C. Other assets

To ease administration, each taxpayer may exclude up to one million dollars of miscellaneous other assets, such as intellectual property, vehicles, jewelry, and so on. Assets in excess of the threshold are valued based on any transaction in the past ten years that established their value, such as a sale or purchase, inflated by the FTB's market rate of return. Where no such transaction exists, valuation is by qualified appraisal.

D. Appraisals and special discounts

Because appraisals have historically been a weak point of the income and estate tax systems, the bill adds a series of safeguards intended to reduce the ability of taxpayers to manipulate appraisals.

The centerpiece of the appraisal safeguards is the appraiser's statement of confidence, which is used as a screening mechanism to determine which set of additional rules apply to police the appraisals. Appraisers engaged by the taxpayer must state with high, medium, or low confidence that the true value of the property does not exceed 150% of the appraiser's estimate. If an appraiser claims high confidence, but FTB ultimately finds that the true value is outside this range, the appraiser is subject to individual penalties that increase depending on the appraiser's fee for appraisal services, along with potentially being subject to additional enforcement and policing rules and penalties.

If appraisers can only offer medium or low confidence estimates, the taxpayer has two options. One is to allow the FTB to obtain an independent, binding appraisal, paid for by the taxpayer. Alternately, the taxpayer may open an optional unliquidated tax claim account ("OUTCA"), as described more below.

Assets do not have to be continually re-appraised. Taxpayers can rely on old appraisals, inflated for FTB's market rate of return (and adjusted for any additions to or withdrawals from the appraised property), so long as they certify that they haven't entered into any transactions that would significantly change the asset's value, such as a merger.

In the estate-tax context, taxpayers commonly use tactics, such as the "family limited partnership," that reduce the appraised value of an asset without much changing its economic value to the taxpayer. The bill provides that intentional efforts to reduce the value of an asset do not affect its taxable value, and authorizes FTB to issue additional regulations to implement that rule. In no case can a partial interest in an asset be taxed at less than the taxpayer's pro rata ownership share, a rule that commentators have suggested as a way to stymie the family limited partnership technique.

V. Unliquidated tax claim accounts

In several different situations, it may be impractical to fully compute and collect tax on an asset in the current tax year. The bill resolves these problem cases with a pair of related mechanisms, the optional unliquidated tax claim account ("OUTCA") and the liquidity-based OUTCA ("LOUTCA"). The general mechanics for both are similar, but with some important differences.

Briefly, when the OUTCA or LOUTCA is available, the taxpayer signs an agreement with the Franchise Tax Board to defer current tax liability--either in whole or in part--in exchange for a future tax payment. The agreement binds the taxpayer and taxpayer's heirs and successors, whether or not they are still in California at the time the future payment comes due, and with this agreement lasting until the taxpayer or the taxpayer's heirs reconcile and close the account to pay the deferred tax obligations. The primary difference is that for OUTCAs only a portion of tax liabilities are deferrable in this manner, whereas for the liquidity-based LOUTCAs the entire tax liability is deferrable with respect to assets to which the LOUTCA is attached.

Typically, the deferred tax payment will be triggered when the underlying asset is sold, or at taxpayer's option in an earlier year. Dividends or similar types of withdrawals of funds from the underlying asset will also trigger immediate taxation to the extent of the withdrawal.

The amount of the deferred tax is calculated through a formula that in effect tracks the percentage of the value of the underlying assets that is owed to California. That percentage is equal to the percentage that would have been paid if not for the OUTCA—usually the taxpayer's top wealth tax rate, but potentially lower in the case of part-year residents. This set-aside grows each year to reflect the fact that the asset would have been annually subject to an additional wealth tax. When the asset is finally sold, the government's share of the sale proceeds is the sale price times the sum of these percentages. For instance, if an OUTCA were settled after one year, the government would receive a percentage of the sale proceeds equal to the taxpayer's wealth tax rate. In effect, the deferred tax bill is inflated or deflated by the asset's internal rate of return.

Taxpayers can make use of the OUTCA/LOUTCA procedure through two main pathways. An OUTCA is an option in the event that an appraiser is unable to estimate value with a high degree of confidence. Taxpayers may opt into a LOUTCA if they can show that they are "liquidity constrained." Although exact details are left to FTB, the bill provides guidance indicating that taxpayers are generally not considered liquidity constrained unless highly illiquid assets make up at least 80% of their net worth. Positions in public companies, or control rights in highly profitable private companies, are not typically to be considered illiquid. In short, the LOUTCA provides a failsafe for taxpayers with paper wealth but who cannot afford to make immediate payments.

VI. Taxation of trusts

A trust is a form of business entity in which distributions of the entity's assets are in the control of a manager or "trustee." Commonly, the contributor or "grantor" of the assets provides instructions for when these assets can be paid out, often vesting the trustee with some discretion about whether to pay them out presently or save them for payment to future generations of beneficiaries. Trusts are an extremely common tax-minimization strategy for the very wealthy. Federal constitutional constraints may limit the efficacy of any state-level effort to respond fully to trust planning, but the bill attempts to make use of all available state authority.

In general, the bill seeks to tax assets held in trust to either the trust, the beneficiaries of the trust, or the grantor. Trusts may elect to be taxable in order to save the beneficiaries and grantors the administrative burden of computing and paying tax on trust assets. If there is no such election, assets are taxed to any beneficiary who has a legal right to receive those assets from the trust in the current tax year. A beneficiary whose right depends on some future event, such as the discretion of the trustee, is not taxed until that event occurs. If neither the trust nor a beneficiary is taxed with respect to a trust asset, then the grantor of that asset is taxed. Beneficiaries and grantors are taxed only if they are California residents, however.

The rules also include a "throwback" tax to account for beneficiaries whose interests depend on future events. If a beneficiary's interest in a trust vests, and no one has previously paid tax on that asset for a past year in which the beneficiary was a California resident, the beneficiary is liable for tax as though they had owned the asset in prior years. Beneficiaries can't be taxed, though, for years in which they were either not

California residents or were not contingent future beneficiaries of the trust. Grantors can elect instead to pay taxes for assets held for contingent beneficiaries, and if this election is made beneficiaries are not subject to the throwback tax. Again, the principle is that one and only one taxpayer is responsible for paying tax on the trust assets. Without these rules, it would be easy for wealthy individuals to place all their assets in trust subject to the "discretion" of a sympathetic trustee, and escape most of the wealth tax.

Still, the net result of these rules is that some families may be able to transfer money through trusts to escape the California wealth tax. A California heir with a non-Californian parent may be a contingent beneficiary of a substantial estate held in trust. This trust will likely not be taxed under the bill, and the California heir may relocate to another state and reside there four years before receiving any distributions from the trust. The heir would thereby pay no wealth tax on the inheritance. However, it is likely that more aggressive efforts to tax this transfer would raise serious federal constitutional issues. Also, these scenarios seem sufficiently limited that this sort of planning should not substantially reduce overall tax revenue.

Charitable trusts (other than so-called "social welfare organizations" exempt from federal tax under section 501(c)(4) of the U.S. Internal Revenue Code) are exempt from the trust tax regime. Split-interest trusts, in which only a portion of the trust is set aside for charitable use, and another portion is used for non-charitable beneficiaries such as grantor's heirs, are not exempt, even on the portion set aside for charitable use. This reflects a judgment that most split-interest trusts are abusive and do not deliver value to charities in any meaningful proportion to their costs to the government.

VII. Liabilities

As a general rule, taxpayer debts and other liabilities reduce worldwide wealth, so that the bill taxes net wealth rather than gross assets. The bill includes a variety of anti-abuse rules to attempt to prevent taxpayers from claiming larger adjustments than would be justified by their economic circumstances.

For example, debts owed to related parties (for this purpose broadened to include charitable organizations to which the taxpayer is a substantial contributor) do not reduce worldwide wealth. This departs from the typical income-tax treatment of debt, which usually permits taxpayers to reduce taxable income as a result of business or investment interest paid to related parties. This rule is a source of very extensive tax planning and is viewed as overly generous by the bill drafters. Similarly, no reduction is allowed for debts paying less than a market rate of interest, on the presumption that such debts are usually entered into for tax-avoiding reasons or otherwise are not likely to require repayment at face value.

In addition, the bill prevents reductions in the current tax year for liabilities that are contingent on future events, such as a “put” option or other derivatives. A taxpayer’s exposure to a future downside risk results in adjustments to worldwide wealth beginning at the time when such risk actually materializes.

VIII. Administration

The bill adds new resources and procedures for ensuring successful administration of the wealth tax.

A. Understatement penalty

The bill provides for an additional 20% penalty, on top of those already available under California law, for large understatements of tax. Large is defined as the lesser of $1 million or 20% of the taxpayer’s tax due on a given return. The penalty rises to 40% in the event the understatement was the result of failing to report assets. Unlike many tax penalties, this understatement applies without regard to the taxpayer’s intent or on what authority they purport to rely. The penalty is waived, however, if taxpayer relied reasonably on a written FTB legal opinion, or if the law changes after the taxpayer files the return, such as might occur if the taxpayer challenges an FTB position and prevails in court.

B. False Claims Act

The California False Claims Act generally allows private citizens to initiate lawsuits alleging that another party has attempted to defraud the state of California. Prevailing plaintiffs can share in a portion of the recovery. The scope of the FCA does not presently allow for actions related to tax claims. The bill therefore extends the FCA to allow for suits related to any “claims, records, and statements” connected to a wealth tax filing. The bill extends an existing FCA provision allowing for triple damages, but only if the underlying amount sought exceeds $200,000, and the bill also allows single consequential damages in a broader range of scenarios (including if it cannot be shown that the taxpayer acted “knowingly” in making false statements connected to a wealth tax filing).

The existing FCA provides that the state of California may join or decline to join an action brought by a private plaintiff. The bill additionally requires that upon request of a plaintiff or defendant, the Attorney General’s office must provide an explanation, suitably redacted to protect confidential taxpayer information, about why it determined that it was not in the state's interest to join a suit. The purpose of this and some related provisions is to foster a default norm whereby the Attorney General's office is expected to intervene either for or against an FCA claim, unless there are specific reasons that justify the Attorney General's office not doing so.

The confidential nature of tax filings makes many tax claims difficult for a private plaintiff. For example, a potential plaintiff may be aware of resources that another taxpayer has taken apparent steps to conceal, but the would-be plaintiff typically cannot know whether those resources have in fact been disclosed to the state. The bill therefore authorizes a new "preliminary investigation" procedure in which potential plaintiffs may submit a request for preliminary investigation to the Attorney General, who may then obtain records and inform the plaintiff whether a potential action would likely have merit.

C. Other enforcement resources

The bill sets aside 1.5% of projected wealth-tax revenues in the first two years of the tax for building new enforcement capacity at the FTB and Attorney General's office. It further establishes a task force whose job is to review and assure ongoing resource needs, particularly those resources needed to ensure a high audit rate among very wealthy taxpayers. FTB is also authorized to hire outside counsel or experts to aid in enforcement.