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California Proposes 16.8% Tax Rate & Wealth Tax...Again, Time To Move?

California legislators have proposed big tax hikes—again, reprising two tax bills introduced in 2020 that failed to pass. With the economy improving and the state hungry for money, perhaps this year will be different. One tax bill would raise the state's already stratospheric top income tax rate by up to 3.5% for very high incomes. The other is a controversial wealth tax. Currently, the income tax rate on individuals tops out at 13.3%, but Assembly Bill 1253 would raise the top tax rate to 14.3% for those making more than $1 million. Over $2 million, you would hit 16.3%, and over $5 million, a top rate of 16.8%. Even before any proposed changes, California's top 1% of income earners pay most of the state's personal income tax revenue (46% in 2016). Last year's bill to raise the tax rate to 16.8% failed, but the new bill comes as the economy is beginning to improve.

Perhaps California wants to be back on top with rates too. Combined New York City and State tax rates top out at 13.53%, eclipsing California's 13.3%, but 16.8% could humble the world. The bills come when it seems clear that federal taxes are going up too, at least for some. And since 2018, the cap on deducting state taxes against federal taxes is only $10,000. If you pay the proposed 39.6% federal rate and can deduct only $10,000 of state taxes, paying much bigger state taxes is even more painful.

For some time, California has been losing citizens for no-tax states like Texas, Nevada, Washington, Wyoming and Florida, and not just the likes of Elon Musk. Indeed, you don't have to move to a no-tax state to pay less. Every other state has lower income tax rates than California, either no tax or lower tax. And many states tax capital gains more favorably, like the IRS. California taxes ordinary income and capital gain the same, up to 13.3%—unless the rate goes up. That prompts sellers of stock, Bitcoin, and other assets facing California's 13.3% tax on capital gains to move then sell. The same for litigants settling big suits who move before they settle. Although moving sounds easy, you need to be thorough and careful so you are not asked to keep paying California taxes. Timing matters too. California audit exposure can be frightening, and in some cases California can assess taxes no matter where you live.

The IRS can generally audit 3 or 6 years depending on the issue, but California can sometimes audit *forever*. Like the IRS, California has an unlimited number of years to audit if you never file an income tax return. That can make continuing to file in California—as a nonresident—a smart play. That way you are just reporting your California source income, but not everything else. California source income would include rental income from California property, Schedule K-1s that you might receive from California partnerships or LLCs could reflect some California source income too. Whether you start filing as a nonresident or not, of course, many people worry that saying goodbye to California taxes can mean hello residency audit. Yet the fact that the top tax rate could go up again may put some people on the move. It's not just income taxes driving the reverse immigration either. The repeated talks of a wealth tax are worrisome, even for those who only aspire to be wealthy.

The wealth tax bill in 2020 failed, but it's back. California Assembly Bill 310 would levy a 1% tax annually on net worth over $50 million, and a 1.5% tax on net worth over $1 billion. It would also require a constitutional amendment to increase the state's current wealth tax cap. The wealth tax bill in 2020 was different, starting the tax at $30 million in assets. There's no question that California is a tax pioneer—remember the property tax revolution of Proposition 13? But pioneer or not, the administrative nightmare that the nation's first wealth tax would bring seems large indeed. Remember, this is not about income, but about accumulated wealth. And it's not about a discreet event such as death, where estate tax kicks in. This would be an annual tax, which is and that's where valuation comes into play. Taxing assets rather than income means major valuation and line-drawing exercises.

Percentage interests in legal entities such as partnerships, LLCs, and hedge funds would evidently have to be valued, and so would interests in businesses. If you are a Californian who owns a 25% of a company in Ohio, the company in Ohio may have to cooperate too. In short, valuation would be complex and involve judgement calls, and it could burden non-California businesses too. Among the more controversial parts of the proposed tax—a tax that itself is highly controversial—are the exit provisions. Suppose that you leave California? It looks like the tax could evidently still get you for four years. Even stepping into California temporarily could be costly, carrying a tax taint. The bill suggest that you could be taxed even as a "temporary resident." Say you have spent at least 120 days in California over the last two years. Alternatively, suppose that you spent at least 150 days in California over the last four years. In either event, you can evidently get slapped with some tax. My cloudy crystal ball suggests that passing this bill would be tough, but who knows.

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