

**ANALYSIS OF ORIGINAL BILL**

Franchise Tax Board

Author: Harman Analyst: Raul Guzman Bill Number: AB 2680

Related Bills: None Telephone: 845-4624 Introduced Date: February 24, 2006

Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Disallowance Of Deduction For Wages Paid To Or On Behalf Of An Unauthorized Alien

**SUMMARY**

This bill would disallow business deductions for wages paid to an unauthorized alien.

**PURPOSE OF THE BILL**

According to the author’s office, the intent of this bill is to stem the flow of illegal immigrants by denying the business deduction for wages, which in turn should discourage employers from hiring those persons.

**EFFECTIVE/OPERATIVE DATE**

This bill is a tax levy and would be effective immediately upon enactment. It would be operative for taxable years beginning on or after January 1, 2007.

**POSITION**

Pending.

**ANALYSIS**

FEDERAL/STATE LAW

Existing state and federal laws generally allow taxpayers engaged in a trade or business to deduct all expenses that are considered ordinary and necessary in conducting that trade or business.

There are also federal and state laws that deny the deduction of certain business expenses, such as expenses for items directly related to illegal activities. Examples of such instances are as follows:

- Lotteries, gaming, touting, robbery, indecent exposure, obscene exhibitions, bawdy and disorderly houses, burglary and housebreaking, larceny and theft, embezzlement, and controlled substances.

Board Position:	Department Director	Date
_____ S		
_____ SA	S. Stanislaus	5/3/06
_____ N		
_____ NA		
_____ O		
_____ OUA		
_____ NP		
_____ NAR		
_____ X PENDING		

- Payments made directly or indirectly to an official or employee of any government if the payments constitute an illegal bribe or kickback.
- Fines or penalties paid to a government for violation of any law.
- Credits or other allowances resulting from the acquisition or control of a corporation to evade or avoid income tax.

Existing California law also prohibits a taxpayer that is deriving rental income from substandard housing located in California from deducting interest, depreciation, or taxes relating to the substandard housing.

### THIS BILL

This bill would disallow business expense deductions for any wages paid to or on behalf of an unauthorized alien.

This bill would define the following terms:

- “Unauthorized alien” means, by reference to federal law, an alien that is not at the time of employment either:
  1. an alien lawfully admitted for permanent residence, or
  2. authorized to be employed by the Attorney General.
- “Wages” means all remuneration for employment, including the cash value of all remuneration and benefits paid in any medium other than cash.

This bill would allow business expense deductions for any wages paid to, or on behalf of, an unauthorized alien if the person or entity is participating in the basic pilot program described in Section 403 of the Illegal Immigration Reform Act of 1996.

This bill would disallow, under the Personal Income Tax Law (PITL) and the Corporation Tax law (CTL), the business expense deduction for wages paid to or on behalf of an unauthorized alien.

### IMPLEMENTATION CONSIDERATIONS

The department has identified the following implementation concerns. Department staff is available to work with the author’s office to resolve these and other concerns that may be identified.

Implementing this bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

This bill would disallow the business expense deduction for wages paid to or on behalf of an unauthorized alien, but is silent regarding the disallowance of other expenses such as social security, Medicare, CA SDI, taxes, insurance or other miscellaneous expenses.

This bill lacks a statutory requirement that the Franchise Tax Board (FTB) can use to determine if an employer employed unauthorized aliens. When a taxpayer claims a business deduction on a tax return, the taxpayer reports total numbers from worksheets, schedules, or working papers. The returns lack detailed information for FTB to determine whether an employee is an authorized alien. In the absence of statutory requirement of how FTB would make such a determination, this provision could create a compliance issue for taxpayers and an administration issue for FTB.

**TECHNICAL CONSIDERATIONS**

The department has identified the following technical concerns:

- Page 2, lines 9, 10, 27, and 28, the word remuneration is misspelled.
- Page 2, lines 7 and 25, the reference to Section 1234a(h)(3), of Title 8, of the U.S.C. is erroneous. The correct reference is, Section 1324a(h)(3).
- Page 2, Lines 14 and 32, Section 403 of the Illegal Immigration Reform Act of 1996 is identified as codified at 8 U.S.C. sec. 1324a. This is incorrect. This provision of the 1996 Act is not codified but may be found in the notes following 8 USC sec. 1324a. Consequently, the reference should be revised to read: 8 U.S.C. sec. 1324a note.

**OTHER STATES' INFORMATION**

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. No comparable trade or business deduction disallowance was found.

**FISCAL IMPACT**

This bill could impact FTB's audit workload by adding an additional issue to review. This could affect many employers under audit to include verifying whether they employ unauthorized aliens or not; the cost could be significant.

**ECONOMIC IMPACT**

Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue gains:

Estimated Revenue Impact of AB 2680 Effective for Tax Years BOA January 1, 2007 Enactment Assumed After June 30, 2006 (Rounded to Nearest Million)			
	2006-07	2007-08	2008-09
Revenue Gain	\$1	\$12	\$12

This analysis does not consider any possible changes in employment, personal income, or gross state product that could result from this measure.

### Revenue Discussion

About 2.6 million unauthorized immigrants were living in California in 2005 and roughly 65% of this population is working at any given time. The population is expected to increase by about 3% annually. For 2007, the number of working unauthorized immigrants is projected at 1.8 million (65% of a projected 2.8 million population). Assuming (1) an average hourly wage of \$10, (2) an average work week of 30 hours, and (3) average employment of 35 weeks per year, the estimated annual wage earnings of an unauthorized alien is \$10,500. As such, the magnitude of wages is roughly \$19 billion (1.8 million x \$10,500).

The revenue impact of this bill would be determined strictly by the amount of wages paid to unauthorized immigrants and not deducted on tax returns *on a self-assessed basis* because the bill lacks a standard for making the determination that a claimed deduction should be disallowed. It is assumed employers would not deduct more than 1% of unauthorized immigrant wages as a result of this proposal. Thus, estimated revenue gains would be around \$11 million per year (\$19 billion wage payments x 1% x 6% marginal tax rate). The figures in the above table are adjusted for fiscal year impacts.

Increased audit activity targeted on employers in industries commonly known to employ unauthorized immigrant workers (agriculture, manufacturing, domestic service, restaurants, construction, resorts) may produce additional revenue gains. The projected impact would likely be minor and occur outside the current budget window.

### **ARGUMENTS/POLICY CONCERNS**

This bill would create differences between federal and California tax law, thereby increasing the complexity of California tax return preparation.

This bill would disallow business expense deductions for any wages paid to or on behalf of an unauthorized alien, but the income received by those unauthorized aliens would be taxable. This could be seen as creating an imbalance by denying the deduction to employers, but requiring the unauthorized alien to report the income.

### **LEGISLATIVE STAFF CONTACT**

Raul Guzman  
Franchise Tax Board  
845-4624  
[raul.guzman@ftb.ca.gov](mailto:raul.guzman@ftb.ca.gov)

Brian Putler  
Franchise Tax Board  
845-6333  
[brian.putler@ftb.ca.gov](mailto:brian.putler@ftb.ca.gov)