Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Revenue & Taxation Committee	Analyst:	Anne Mazur	Bill Number:	AB 1746
Related Bills:	None	Telephone:	845-5404	Introduced Date:	March 22, 2007
		Attorney:	Daniel Biedler	Sponsor:	Franchise Tax Board

SUBJECT: Broaden The Disallowance Of Deductions For Expenses Attributable To Illegal Activities

SUMMARY

This billl would amend the Revenue and Taxation Code (R&TC) to broaden the list of crimes for which associated expenses would be disallowed as tax deductions.

PURPOSE OF THE BILL

The purpose of this Franchise Tax Board (FTB) – sponsored bill is to prohibit a taxpayer that perpetrates certain crimes from claiming a deduction on their tax return for expenses incurred in their criminal endeavor.

EFFECTIVE/OPERATIVE DATE

If enacted in the 2007 legislative session as a tax levy, this bill would be effective immediately upon enactment, and apply to taxable years that are open under the applicable statute of limitations on or after that date.

POSITION

Support.

On March 6, 2002, the Franchise Tax Board voted 2-0, with the Director of Finance abstaining, to sponsor the language included in this bill.

Board Position:			Department Director	Date
X S	NA	NP		
SA	O	NAR	Selvi Stanislaus	4/10/07
N	OUA	PENDING		

BACKGROUND

In several recent tax evasion cases involving crimes against the elderly and insurance fraud, FTB's investigating Special Agent was required to allow expense deductions attributable to the illegal activity in computing taxable income because these crimes are not specifically included in the deduction disallowance provisions in the current statute. The Deputy District Attorneys prosecuting these cases have expressed frustration and concern regarding the limited nature of the disallowance provisions. Because particular crimes are not specified, prosecutors complain their ability to charge and penalize defendants fully is compromised, and the opportunity exists for the defendant's counsel to challenge the validity of FTB's tax liability computations.

ANALYSIS

FEDERAL LAW

Under current federal law**,** any income from an illegal business, an actual crime, or an immoral or unethical practice is included in taxable income. Illegal payments, such as bribes or kickbacks, are not deductible. Fines and penalties for violating a law, including tax penalties, also are not deductible. Losses from illegal transactions are not deductible if there is a clear public policy supporting the disallowance of the deduction.

Federal law generally allows the deduction of ordinary and necessary business expenses incurred in operating an illegal trade or business. However, all deductions or credits are disallowed when the trade or business consists of drug trafficking.

STATE LAW

State tax law is similar to federal tax law in this context, except that under Personal Income Tax Law (PITL) Section 17281 and Corporation Tax Law (CTL) Section 24436, deductions from gross income are not allowed if the income is directly derived from, or directly tends to promote or further, illegal activities relating to lotteries, gaming, or horse racing. Sections 17282 and 24436.1 disallow deductions, including cost of goods sold, from gross income for other specified illegal activities, including pimping or pandering, larceny, obscene matter, robbery, burglary, controlled substances, embezzlement, and indecent exposure.

Current state tax law also allows misdemeanor and felony charges to be filed in instances of criminal and willful violations of the state income tax laws, such as fraud, tax evasion, and willful acts involving fraudulently obtained refunds. Charges may be filed against a taxpayer for improperly claming expense deductions from income derived from illegal activities for which a deduction is not allowed.

THIS BILL

This bill would amend current law to deny a deduction for expenses, including costs of goods sold, attributable to income from any criminal activity punishable under the Penal Code and specified sections of the Health and Safety Code relating to drug trafficking and the Insurance Code relating to insurance fraud.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would not significantly impact the department's programs and operations.

FISCAL IMPACT

This bill would not significantly impact the department's costs.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following gains in state income tax revenue:

Estimated Revenue Impact of AB 1746 Applicable For Cases With Open Statutes On Or After The Effective Date Enactment Assumed After June 30, 2007			
Fiscal Year	2006/07	2007/08	2008/09
Revenue Gain	a/	b/	c/

a/ Insignificant revenue gain of less than $150,000
b/ Negligible revenue gain of less than $250,000
c/ Minor revenue gain of less than $500,000

Revenue Discussion

This analysis does not consider the possible changes in investment activity, employment, personal income, or gross state product that could result from this bill.

According to FTB's Investigations Unit, approximately $3.5 million in additional tax is assessed annually from criminal cases where deductions against income received from illegal activities are presently allowed. Assuming a 6% effective tax rate, this equates to approximately $60 million ($3.5m ÷ 6%) in taxable net income assessed.

Based on current and anticipated workloads, this proposal would primarily impact medical insurance fraud cases. Investigations staff has determined, based on external studies, that legitimate medical practices typically incur expenses that offset 60% of their gross income. It is expected that the expense-to-gross income ratio will be much smaller in the case of fraudulently derived income. It was assumed that in the case of fraud the expenses would only be 20% of gross income. Therefore, the $60 million in taxable net income would translate into $75 million in gross income ($60m / 80%) after increasing taxable net income by the portion of deductions that would be disallowed. This bill, therefore, would disallow $15 million in deductions, resulting in additional state tax assessments of about $1 million ($15m x 6%).

Investigation cases have a historical collection rate of 58% of total dollars assessed. Thus, the actual revenue yield is around $600,000 annually in terms of payments received ($1m x 58%). This estimated revenue gain is expected to take five years to fully phase-in, accounting for the time lag between assessments and collection. Finally, because this bill would impact prior tax years, revenues shown in the above table are accrued back by one year.

ARGUMENTS/POLICY CONCERNS

By prohibiting deductions for expenses attributable to income from a criminal activity, public expenditures provided through the state tax system would be reserved for legitimate business expenses.

LEGISLATIVE STAFF CONTACT

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