Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Calderon	Analyst:	Victoria Favorito	Bill Number:	ABX3 26
Related Bills:	See Legislative History	Telephone:	845-3825	Introduced Date:	January 29, 2009
		Attorney:	Patrick Kusiak	Sponsor:	Franchise Tax Board

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

SUMMARY

This bill 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 three-member 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

This bill is a tax levy, which would be effective immediately 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 three-member Franchise Tax Board voted 2-0, with the Director of Finance abstaining, to sponsor the language included in this bill.

SUMMARY OF SUGGESTED AMENDMENTS

BACKGROUND

In several recent tax evasion cases involving crimes against the elderly and insurance fraud, the 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 that their ability to charge and penalize defendants fully is compromised, and the opportunity exists for the defendant's counsel to challenge the validity of the FTB's tax liability computations.

Board Position:			Department Director	Date
X S	NA	NP		
SA	O	NAR	Brian Putler	11/17/09
N	OUA	PENDING		

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 claiming 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 <u>any</u> criminal activity punishable under the Penal Code, which can include misdemeanor activities unrelated to a taxpayer's business activity, and specified sections of the Health and Safety Code relating to drug trafficking and the Insurance Code relating to insurance fraud.

This bill would also require a prior, final California court determination on the merits of the legality of the taxpayer's activities to deny any deductions for expenses. This requirement is consistent with the department's practice to deny such deductions under existing law. Currently, the department disallows deductions attributable to illegal activities only where there has been a criminal conviction or a determination by a court of the additional tax liability related to illegal activity.

IMPLEMENTATION CONSIDERATIONS

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

LEGISLATIVE HISTORY

AB 1746 (Revenue and Taxation Committee, 2007/2008), would have broadened the list of crimes for which associated expenses would be disallowed as a tax deduction. The bill failed passage out of the Assembly Revenue and Taxation Committee. AB 1746 is similar to this bill.

FISCAL IMPACT

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

ECONOMIC IMPACT

Revenue Estimate

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

Estimated Revenue Impact of ABX3 26 as Introduced on 1/29/09 Estimated Based on Open Taxable Years Not Closed by a Statute of Limitations Enactment Assumed After 6/30/09			
Fiscal Year	2008/09	2009/10	2010/11
Revenue Gain	$50,000	$150,000	$250,000

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

Revenue Discussion

The revenue impact is dependent on the amount of business expense deductions that are denied under the bill that would otherwise be allowed under current law. Based on current and anticipated workloads, the bill would primarily impact medical insurance fraud cases. According to the FTB's Investigations Unit, approximately $3.5 million in additional tax is assessed annually from these types of criminal cases. Assuming a 6 percent effective tax rate, the $3.5 million in taxes imposed equates to approximately $60 million (≈$3.5 M÷ 6%) of taxable net income. This bill would result in more severe tax consequences for insurance fraud cases because it allows the FTB to disallow business deductions deemed related to the criminal activity.

FTB staff has determined that legitimate medical practices typically incur expenses that offset 60 percent of gross income. It is expected that expense ratios would be much less in criminal cases involving illegal income, such as Medi-Cal fraud. For cases involving illegal income, it is assumed that individuals involved in fraud would understate expenses to not draw attention to the illegal income, thus legitimate operating expenses would amount to approximately 20 percent of gross income. The $60 million in taxable net income currently assessed annually in such cases would grow to $75 million in gross income under the bill because some a portion of commingled expenses would be denied ($60M ÷ 80%). This results in an estimated $15 million ($75M gross less $60M net) of reported business deductions being denied each year. This yields additional tax revenues of about $900,000 annually ($15M x 6%).

Investigation cases have a historical collection rate of 58 percent of total dollars assessed. Thus, the actual revenue yield is approximately $500,000 annually in terms of tax revenue collected ($900,000 x 58%). This estimated revenue gain is expected to take five years to be fully recognized because it accounts for the time lag between assessments and collection. Because the proposed law would apply only after a court has made a final determination on the legality of the taxpayer's activities, revenue gains are projected to occur in the 2010 calendar year, or in the second half of fiscal year 2009-10. The revenues collected in the 2009-10 fiscal year represent the recovery of a prior year tax liability that are accrued back one year to fiscal year 2008-09.

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

Legislative Analyst	Revenue Director	Asst. Legislative Director
Victoria Favorito	Jay Chamberlain	Patrice Gau-Johnson
(916) 845-3825	(916) 845-3375	(916) 845-5521
victoria.favorito@ftb.ca.gov	jay.chamberlain@ftb.ca.gov	patrice.gau-johnsont@ftb.ca.gov