

Franchise Tax Board

**ANALYSIS OF ORIGINAL BILL**

Author: Gatto Analyst: Janet Jennings Bill Number: AB 1369

Related Bills: None Telephone: 845-3495 Introduced Date: February 18, 2011

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

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

**SUMMARY**

This bill would deny a deduction for expenses, including costs of goods sold, incurred from certain criminal activities.

**RECOMMENDATION AND SUPPORTING ARGUMENTS**

Support.

On March 6, 2002, FTB voted 2-0, with the Director of Finance abstaining, to support the language included in this bill.

**PURPOSE OF THE BILL**

The purpose of this FTB supported bill is to prohibit deductions for expenses attributable to income from a criminal activity, thereby ensuring deductions are reserved for legitimate business expenses.

**EFFECTIVE/OPERATIVE DATE**

If enacted in the 2011 legislative session, this bill would be effective immediately and would specifically apply to all taxable years that remain open under the applicable statute of limitations as of the effective date.

**ANALYSIS**

FEDERAL LAW

Under federal law, gross income is the starting point in determining taxable income. Gross income is broadly defined as all income from whatever source derived—including income obtained from an illegal business, an actual crime, or an immoral or unethical practice.

Board Position:			
<u> X </u> S	_____ NA	_____ NP	
_____ SA	_____ O	_____ NAR	
_____ N	_____ OUA		

Executive Officer	Date
Selvi Stanislaus	04/25/11

Federal law generally allows the deduction from income of ordinary and necessary business expenses incurred in operating a trade or business—including an illegal business. Notwithstanding the general rule, all deductions or credits are expressly disallowed when the trade or business consists of drug trafficking. Other nondeductible expenses include:

- Illegal payments, such as bribes or kickbacks.
- Fines and penalties for violating a law, including tax penalties.
- Losses from illegal transactions, if there is a clear public policy supporting the disallowance of the deduction.

### STATE LAW

California uses the federal definition of gross income and allows deductions for ordinary and necessary business expenses.

Expenses that cannot be deducted from income include those directly derived from or that directly tend to promote or further illegal activities relating to:

- Lotteries,
- Gaming, or
- Horse racing.

Additionally, California law disallows deductions, including cost of goods sold, from gross income for the following specified illegal activities:

- Pimping or pandering
- Larceny
- Obscene matter
- Robbery
- Burglary
- Illegal sales of controlled substances
- Embezzlement
- Indecent exposure

It is a misdemeanor and felony under current law to file a fraudulent tax return, to evade tax, or to willfully or fraudulently obtain a tax refund. It is also a crime to claim an expense deduction for an illegal activity for which a deduction is not allowed.

### THIS BILL

This bill would amend current law to deny a deduction for expenses and costs of goods sold attributable to:

- Any person that commits insurance fraud by referring or procuring clients, cases, patients, or customers to a third party for compensation or inducement.
- Crimes listed under the "California Control of Profits of Organized Crime Act" found in California Penal Code sections 186, et seq. The full list of these crimes can be found in Appendix A.

### IMPLEMENTATION CONSIDERATIONS

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

### TECHNICAL CONSIDERATIONS

The department has identified the following technical concerns.

The attached amendments would clarify that the additional crimes for which expenses would be disallowed by this bill apply to all taxable years currently open for adjustment.

### **FISCAL IMPACT**

This bill would not impact the department's costs.

### **ECONOMIC IMPACT**

#### Revenue Estimate

Estimated Revenue Impact of AB 1369 For Taxable Years Open to the Statute of Limitations On or After January 1, 2011 Enactment Assumed After June 30, 2011 (\$ in Dollars)				
2010-11	2011-12	2012-13	2013-14	2014-15
+\$50,000	+\$150,000	+\$250,000	+\$350,000	+\$450,000

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

### **SUPPORT/OPPOSITION**

Support: FTB.

Opposition: None provided.

### **ARGUMENTS**

Pro: Proponents would argue that this bill would ensure that criminals cannot utilize tax deductions on income derived from criminal profiteering or fraudulent insurance activities.

Con: Opponents would argue that the cost to produce income should be deductible regardless of legality.

### **LEGISLATIVE STAFF CONTACT**

Janet Jennings

Legislative Analyst, FTB

(916) 845-3495

[janet.jennings@ftb.ca.gov](mailto:janet.jennings@ftb.ca.gov)

Brian Putler

Legislative Director, FTB

(916) 845-6333

[brian.putler@ftb.ca.gov](mailto:brian.putler@ftb.ca.gov)

## Appendix A

Penal Code Section 186.2. For purposes of this chapter, the following definitions apply:

(a) "Criminal profiteering activity" means any act committed or attempted or any threat made for financial gain or advantage, which act or threat may be charged as a crime under any of the following sections:

- (1) Arson, as defined in Section 451.
- (2) Bribery, as defined in Sections 67, 67.5, and 68.
- (3) Child pornography or exploitation, as defined in subdivision (b) of Section 311.2, or Section 311.3 or 311.4, which may be prosecuted as a felony.
- (4) Felonious assault, as defined in Section 245.
- (5) Embezzlement, as defined in Sections 424 and 503.
- (6) Extortion, as defined in Section 518.
- (7) Forgery, as defined in Section 470.
- (8) Gambling, as defined in Sections 337a to 337f, inclusive, and Section 337i, except the activities of a person who participates solely as an individual bettor.
- (9) Kidnapping, as defined in Section 207.
- (10) Mayhem, as defined in Section 203.
- (11) Murder, as defined in Section 187.
- (12) Pimping and pandering, as defined in Section 266.
- (13) Receiving stolen property, as defined in Section 496.
- (14) Robbery, as defined in Section 211.
- (15) Solicitation of crimes, as defined in Section 653f.
- (16) Grand theft, as defined in Section 487.
- (17) Trafficking in controlled substances, as defined in Sections 11351, 11352, and 11353 of the Health and Safety Code.
- (18) Violation of the laws governing corporate securities, as defined in Section 25541 of the Corporations Code.
- (19) Any of the offenses contained in Chapter 7.5 (commencing with Section 311) of Title 9, relating to obscene matter, or in Chapter 7.6 (commencing with Section 313) of Title 9, relating to harmful matter that may be prosecuted as a felony.
- (20) Presentation of a false or fraudulent claim, as defined in Section 550.
- (21) False or fraudulent activities, schemes, or artifices, as described in Section 14107 of the Welfare and Institutions Code.
- (22) Money laundering, as defined in Section 186.10.
- (23) Offenses relating to the counterfeit of a registered mark, as specified in Section 350.
- (24) Offenses relating to the unauthorized access to computers, computer systems, and computer data, as specified in Section 502.
- (25) Conspiracy to commit any of the crimes listed above, as defined in Section 182.

(26) Subdivision (a) of Section 186.22, or a felony subject to enhancement as specified in subdivision (b) of Section 186.22.

(27) Any offenses related to fraud or theft against the state's beverage container recycling program, including, but not limited to, those offenses specified in this subdivision and those criminal offenses specified in the California Beverage Container Recycling and Litter Reduction Act, commencing at Section 14500 of the Public Resources Code.

(28) Human trafficking, as defined in Section 236.1.

(29) Theft of personal identifying information, as defined in Section 530.5.

(30) Offenses involving the theft of a motor vehicle, as specified in Section 10851 of the Vehicle Code.

(31) Abduction or procurement by fraudulent inducement for prostitution, as defined in Section 266a.

Analyst	Janet Jennings
Telephone #	(916) 845-3495
Attorney	Pat Kusiak

FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO AB 1369

**AMENDMENT 1**

On page 3, revise lines 9 to 12, inclusive, to read as follows:

(c)(1) Except as provided in paragraphs (2) and (3), this section, ~~including amendments made by the act amending this subdivision,~~ shall be applied with respect to taxable years, which have not been closed by a statute of limitations, res judicata, or otherwise, as of September 14, 1982.

(2) The amendments made to this section by Chapter 962 of the Statutes of 1984 shall be applied with respect to taxable years which have not been closed by a statute of limitations, res judicata, or otherwise, as of January 1, 1985.

(3) The amendments made to this section by the act adding this paragraph shall be applied with respect to taxable years, which have not been closed by a statute of limitations, res judicata, or otherwise, as of the effective date of that act.

On page 4, revise lines 18 to 21, inclusive, to read as follows:

c)(1) Except as provided in paragraphs (2) and (3), this section, ~~including amendments made by the act amending this subdivision,~~ shall be applied with respect to taxable years, which have not been closed by a statute of limitations, res judicata, or otherwise, as of September 14, 1982.

(2) The amendments made to this section by Chapter 962 of the Statutes of 1984 shall be applied with respect to taxable years, which have not been closed by a statute of limitations, res judicata, or otherwise, as of January 1, 1985.

(3) The amendments made to this section by the act adding this paragraph shall be applied with respect to taxable years, which have not been closed by a statute of limitations, res judicata, or otherwise, as of the effective date of that act.