

# ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Calderon Analyst: Janet Jennings Bill Number: SB 884

Related Bills: See Legislative History Telephone: 845-3495 Amended Date: March 24,2011

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

**SUBJECT:** FTB & BOE Authorized To Sell Tax Liabilities To Investors Subject To Automatic Stay On Collection Of Taxes Pursuant To Bankruptcy Proceeding

## SUMMARY

This bill would authorize the Franchise Tax Board (FTB) to sell certain tax debts to investors.

## RECOMMENDATION

No position.

## Summary of Amendments

The March 24, 2011, amendments removed the bill's provisions related to legislative intent and replaced them with the provisions discussed in this analysis. This is the department's first analysis of the bill.

This analysis only addresses the provisions of this bill that impact the department's programs and operations.

## PURPOSE OF THE BILL

It appears the purpose of the bill is to accelerate recovery of tax debts where collection is deferred due to bankruptcy.

## EFFECTIVE/OPERATIVE DATE

This bill would become effective January 1, 2012, and would be operative as of that date.

## ANALYSIS

### FEDERAL LAW

The Internal Revenue Service (IRS) does not sell its debts. In March 2009, the IRS, after conducting an extensive review of its private debt collection program, including the cost effectiveness of the effort, decided not to renew its contracts with two private debt collection agencies.

Board Position:			
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## STATE LAW

Under the Accounts Receivable Management Act (ARMA; SB 1838; Stats. 1994, Ch. 1224), any state agency may sell or assign part or all of its accounts receivable to a private debt collector when, among other things, it is likely to generate more net revenue than equivalent state efforts.

The FTB is authorized to contract with private collection companies to collect delinquent taxes and other debts administered by the FTB that are owed by California residents or those residing outside of California. The FTB may enter into an agreement with the companies that provide for the rate and manner of payment for the contracted services. These agreements are as follows:

- The in-state private collection company's commission is paid from the amount the company collects. The commission is not added to the amount to be collected from the debtor. A special fund, the Delinquent Tax Collection Fund, was created for purposes of paying the contract expenditures of this program. The company's collections are deposited into the personal income tax (PIT) Fund and the amount needed to pay the contract costs are transferred from the PIT Fund to the Delinquent Tax Collection Fund for payment of this expenditure to reimburse the FTB. The funds transferred are continuously appropriated without regard to fiscal years.
- For out-of-state collections, the private collection company can add its commission to the tax debt it is collecting from the taxpayer. Therefore, an appropriation from the General Fund to recover the FTB's cost is unnecessary.

## THIS BILL

This bill would do the following:

- Authorize the FTB to sell to investors those tax liabilities that are subject to an automatic stay on collection in a federal bankruptcy case.
- The FTB would be required to contract with an independent firm that has demonstrated expertise in marketing and selling distressed assets. The selection of the firm would be governed by the request for proposal process in the Public Contract Code.
- Establish conditions, requirements, and standards for consultants hired to assist the state in marketing tax liabilities subject to automatic stay on collection.

## 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.

The bill would provide the FTB with authority to sell only bankruptcy claims that are subject to the automatic stay. The FTB would only be able to sell its claims prior to the confirmation of a bankruptcy plan because bankruptcy plan confirmation generally terminates the automatic stay. The types of claims that would be expected to be attractive to investors are those in large business reorganization cases filed under Chapter 11. In most cases, the FTB's bankruptcy claims are not resolved by the time a bankruptcy plan is confirmed.

For example, if a disputed audit assessment is unresolved at the time the business files for bankruptcy, the FTB would be unable to make the type of representations that normally accompany these types of sales, such as the representation that the amount of the claim is a final debt.

The bill would provide the authority to sell the bankruptcy claim yet the language does not provide the FTB with the authority to disclose information to the potential purchaser about the basis of the FTB claim. Current disclosure laws that are in place to protect taxpayer confidentiality would need to be revised to allow the FTB to provide information to the potential purchaser. Without such changes, the FTB would be unable to make adequate disclosures of the underlying claims that would allow for purchasers to evaluate or collect the claims.

The bill's language is silent regarding the collection methods available to the debt purchaser and the taxpayer's ability to file a suit for refund. The language should be clarified to explain that, unless the sale is canceled, the debts sold would be unable to be collected using statutory provisions governing the collections of taxes. The bill would then need language defining the rights and remedies of the debtor and the purchaser (i.e. interest rates charged, due process, disputed debts, lien filing, and litigation). Article XIII, section 32 of the California Constitution allows taxpayers to file suit for refund of a disputed tax after full payment. It is unclear how this provision would apply to a debt that is satisfied after sale to a third party. It is suggested that the bill be amended to specify whether the taxpayer maintains the ability to file a claim for refund on a debt that has been sold and to specify the party responsible for payment of the approved claim.

The bill would allow the FTB to compromise and settle the amount that the FTB would receive through the sale. If the amount of the tax liability is compromised, it is unclear whether such a compromise would likewise reduce the amount that could be collected by the purchaser of these tax liabilities. It is suggested that the bill be amended to specify whether the tax debts would be sold at a discount while permitting the purchaser to collect the full amount owed.

The bill would be operative on January 1, 2012, but lacks a specific operative date. It is recommended that the bill be amended to clarify whether existing claims can be considered for sale or whether the bill would apply to only new claims that come in to existence on or after January 1, 2012.

The bill fails to address the issue of a bankruptcy case dismissal. It is suggested the bill be amended to clarify if it is the responsibility of the independent debt purchaser to facilitate the return of the account and full payment of the claim to the FTB when a bankruptcy case is subsequently dismissed.

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

## TECHNICAL CONSIDERATIONS

This bill uses the term "investors." It may be more appropriate to use the term "purchaser."

This bill uses the terms "tax liabilities" and "accounts receivable" interchangeably. The bill should be amended to use consistent terms.

This bill uses the phrase “bankruptcy proceeding” when the correct terminology would be “bankruptcy case.” The bill should be amended to replace “bankruptcy proceeding” with the term “bankruptcy case.”

## **LEGISLATIVE HISTORY**

SB 3 (Ch. 31, Stats 1993) among other items, allows the FTB to contract with private collection agencies to collect unpaid debts administered by the FTB and provides a continuous appropriation for the FTB to pay for the costs of contracting with private collection agencies.

AB 2958 (Canciamilla, 2003/2004) would have allowed the FTB to contract with private collection agencies to collect unpaid debts administered by the FTB and would have provided a continuous appropriation for the FTB to pay for the costs of contracting with private collection agencies. This bill failed to pass the Assembly Revenue and Taxation Committee.

## **OTHER STATES' INFORMATION**

Review of *Illinois, Massachusetts, Michigan, Minnesota, and New York* laws found no comparable provisions that would permit the sale of tax liabilities that are subject to an automatic stay to a third party. These states were reviewed because of the similarities between income tax laws, size, and population.

## **FISCAL IMPACT**

This bill could require the FTB to make programming changes to the department's accounts receivable and collection systems. As a result, this bill would impact the department's budget. The additional costs have not been determined at this time. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

## **ECONOMIC IMPACT**

It may be feasible for the FTB to sell certain claims subject to an automatic stay to a purchaser. However, the bill lacks details about how the transactions are envisioned to operate. In the absence of the foregoing information, the FTB is unable to provide a revenue estimate.

In addition, the state lacks experience in forecasting these sales. Collection rates and timelines vary significantly between personal income and corporate taxpayers and for the various chapters of bankruptcies. With the uncertainties inherent in the economic recovery and the lag time associated with the variables, estimating the future value of claims, collection rates, and the associated timeline has a large probability of error.

## **SUPPORT/OPPOSITION**

Support: None provided.

Opposition: None provided.

## **ARGUMENTS**

Pro: It could be argued that it would be cost beneficial to sell a bankruptcy debt at a discount rather than waiting for full payment of the liability over several years.

Con: Opponents would argue that it is short-sighted to sell a state tax debt at a discount when the state will receive payment of the claim through resolution of the bankruptcy case. Additionally, due to the nature and complexity of tax debts, the purchaser of the debt would lack the ability to explain the debt to the taxpayer or defend the claim in litigation.

## **POLICY CONCERNS**

California has a self-assessed tax system that relies on the responsiveness of individual and corporate taxpayers to report the proper amount of tax. A self-assessed tax system works in part because the taxpayer has confidence that the information reported to the government will be confidential and used only for the specified purposes. If tax information is sold, used, or disclosed for other than the specified purposes, the effectiveness of the state's self-assessed tax system may be impacted.

The FTB is in the process of implementing the Enterprise Data to Revenue (EDR) project. The EDR project will allow the FTB to use technology to leverage the data that the department has to more effectively administer the tax system. The EDR project is expected to generate approximately \$2.8 billion additional in revenue for the State by fiscal year 2016/2017. The EDR project is a benefit-based procurement; the vendor only gets paid when revenues exceed a determined baseline. The bankruptcy claims that are proposed to be sold by this bill would impact the accounts receivables that are included in the baseline. Changes in the baseline revenue would be a risk to the EDR contract.

Purchasing agreements for bankruptcy debts may include a provision that the state defend its claim during and after the bankruptcy. The risk of litigation expenses could outweigh any potential benefit from the sale of the debt.

## **LEGISLATIVE STAFF CONTACT**

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