Franchise Tax Board # ANALYSIS OF ORIGINAL BILL

Author:	Wieckowski	Analyst:	Jessica Deitchman	Bill Number:	SB 66
Related Bills:	See Legislative History	Telephone:	845-6310	Introduced Date:	January 5, 2017
		Attorney:	Bruce Langston	Sponsor:	

SUBJECT: Business Expense Deduction/Disallow Punitive Damages Deduction

SUMMARY

This bill would, under the Personal Income Tax law and the Corporation Tax Law, disallow a deduction for any amount paid or incurred for punitive damages.

RECOMMENDATION – NO POSITION

REASON FOR THE BILL

The reason for this bill is to eliminate the tax benefit allowed to taxpayers that are subject to paying punitive damages for wrongdoing by repealing the deduction for punitive damages.

EFFECTIVE/OPERATIVE DATE

As a tax levy, this bill would be effective immediately upon enactment, and specifically operative for taxable years beginning on or after January 1, 2018.

FEDERAL/STATE LAW

Current 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, unless specifically excluded by statute. No deduction is allowed for any fine or similar penalty paid to a government for a violation of law. Individuals are allowed to deduct ordinary and necessary expenses paid or incurred for the production of income and for the management, conservation, or maintenance of property held for the production of income. The expenses must not be a nondeductible personal living expense or exceed specific statutory limits. Punitive damages that are paid as a result of a judgment or settlement against a taxpayer in connection with the operation or a trade or business or the production of income or the management, conservation, or maintenance of property held for the production of income may be deductible as ordinary and necessary expenses.

THIS BILL

For taxable years beginning on or after January 1, 2018, this bill would deny a deduction for punitive damages paid or incurred in connection with any judgment in, or settlement of, any action.

IMPLEMENTATION CONSIDERATIONS

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.

LEGISLATIVE HISTORY

AB 458 (Weickowski, 2013/2014) was substantially similar to this bill and would have disallowed the deduction of punitive damages paid or incurred in connection with any judgment in, or settlement of, any action. AB 458 failed to pass out of the Senate by the constitutional deadline.

AB 1276 (Feuer, 2011/2012) was substantially similar to this bill and would have disallowed the deduction of punitive damages paid or incurred in connection with any judgment in, or settlement of, any action. AB 1276 failed to pass out of the Assembly by the constitutional deadline.

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.

All six states follow the federal rules that allow the deduction of punitive damages.

FISCAL IMPACT

The department's costs to implement this bill have yet to be determined. As the bill moves through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

ECONOMIC IMPACT

This bill would result in the following revenue gain:

Estimated Revenue Impact of SB 66 As Introduced January 5, 2017 Assumed Enactment After June 30, 2017		
2017-18	2018-19	2019-20
+ $600,000	+ $1,200,000	+ $1,200,000

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

Revenue Discussion

This revenue estimate is based on a proration of the Joint Committee on Taxation (JCT) federal projections for the President's Fiscal Year 2016 Budget Proposal. In the March 2015 projections, the JCT estimated the federal revenue impact of the disallowing this deduction for punitive damages to be $38 million in federal fiscal year 2018. The equivalent loss to California is estimated to be approximately $1.2 million per year.

To determine California's share of the federal loss, federally reported data was used to calculate that 12 percent of nationally reported personal and corporate income was from California. It is assumed that the portion of punitive damages issued to California taxpayers would be comparable to the size of the income attributed to California. Then federal and state tax rates for individuals and corporations were analyzed to estimate a federal/state tax adjustment of 26 percent. These values were combined to estimate California's loss.

The tax year estimates are converted to fiscal year estimates, and then rounded and reflected in the above table.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

ARGUMENTS

Proponents: Proponents may argue that eliminating the deductibility of punitive damages would eliminate a tax benefit that reduces the incentive to change behavior found unacceptable.

Opponents: Opponents may argue that eliminating the deductibility of punitive damages would increase taxes on businesses, as well as the net costs of litigation, burdening the economy and increasing the costs of goods and services to the average consumer.

POLICY CONCERNS

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

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