

BILL ANALYSIS

Department, Board, Or Commission	Author	Bill Number
Franchise Tax Board	Gatto	AB 1369

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.

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

PURPOSE OF 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

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.

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.

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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.

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.

APPOINTMENTS

None.

SUPPORT/OPPOSITION¹

Support: FTB
 Association of California Insurance Companies
 Liberty Mutual Group

Opposition: None.

VOTES

Assembly Floor	06/02/11	Y: 75 N: 0
Senate Floor	09/06/11	Y: 39 N: 0

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¹ As reported by the Senate Rules Committee Analysis August 17, 2011, http://www.leginfo.ca.gov/pub/11-12/bill/asm/ab_1351-1400/ab_1369_cfa_20110817_112020_sen_floor.html (as of September 7, 2011).