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**To:** Chair Miadich and Commissioners Baker, Cardenas, Hatch, and Wilson

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**Subject:** Sources of Income to an Official's Business Entity Under the Act's Conflict-of-Interest Provisions for Disqualification and Reporting.

**Date:** February 8, 2021

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### SUMMARY

At the request of the Commission, Staff has prepared this memorandum addressing questions raised at the Commission's January 2021 Meeting regarding the application of the Political Reform Act ("Act"), including disqualification and reporting rules, to income received by an official through a business entity.

For disqualification, there is generally no distinction between a direct source of income to an official as compared to a source of income to a business in which the official has an interest of 10-percent or more. In either circumstance, an official has an interest in any source of income of \$500 or more in the 12 months prior to the decisions, and the official is disqualified from taking part in any decision implicating the source if it is reasonably foreseeable that the decision will have a material financial effect on the source. (Section 87103.)

Notwithstanding disqualification rules, the Act's reporting rules do differentiate between income received directly by an official and income received by a business entity in which the official has an interest. For income received directly by an official, the identity of the source of the income is generally reported if the cumulative income from the source is \$500 or more in the reporting period. (Section 87207(a)(1) and 87302(b).) However, if an official receives income through a business entity, the identity of the source must be disclosed only if the official's ownership interest in the business entity is 10-percent or greater and the official's pro rata share of gross receipts from that source is \$10,000 or more. (Section 87207(b)(2) and 87302(b).)

In summary, an official reporting income received directly reports the identity of the source at a lower threshold than an official reporting income received through a business entity. These provisions are statutory and adopted to balance the burden of reporting for officials with interests in business entities, which may have many customers or clients. It could be burdensome to require reporting the identity of sources of income to all business entities at a \$500 threshold.

## ANALYSIS

### *Disqualification*

The Act's conflict-of-interest provisions require officials to recuse themselves from governmental decision in which they have a financial interest. Under Section 87100, "No public official ... shall make, participate in making or in any way attempt to use his official position to influence a governmental decision in which he knows or has reason to know he has a financial interest." An official has a "financial interest" in a decision "if it is reasonably foreseeable that the decision will have a material financial effect, distinguishable for its effect on the public generally" on certain enumerated interests including:

- Any business entity in which the public official has an interest valued at \$2,000 or more (Section 87102(a)), or in which the public official is a director, officer, partner, trustee, employee, or holds any position of management (Section 87102(e)).
- Any source of income aggregating to \$500 or more provided, promised, or received by the official within 12 months prior to a governmental decision. (Section 87103(c).)

With limited exceptions, income includes any payment received including:

“[A]ny salary, wage, advance, dividend, interest, rent, proceeds from any sale, gift, including any gift of food or beverage, loan, forgiveness or payment of indebtedness received by the filer, reimbursement for expenses, per diem, or contribution to an insurance or pension program paid by any person other than an employer, and including any community property interest in the income of a spouse.” (Section 82030(a).)

As pertinent to this discussion, "income" is also defined to include, "a pro rata share of any income of any business entity or trust in which the individual or spouse owns, directly, indirectly or beneficially, a 10-percent interest or greater." (Section 82030(a).) A "business entity" is "any organization or enterprise operated for profit, including but not limited to a proprietorship, partnership, firm, business trust, joint venture, syndicate, corporation or association." (Section 82005.)

Under these provisions, an official will be disqualified from a decision implicating any business entity in which the official has an interest if it is reasonably foreseeable that the decision will have a material financial effect on the entity. The official is potentially disqualified regardless of the nature of the entity. In other words, whether the entity is a sole proprietorship, partnership, or corporation has no bearing on the determination of whether an official is disqualified based on a financial effect on an interest in the business.

Similarly, there is no distinction between disqualification for an official that has received income directly, or income through a sole proprietorship. In either circumstance, the official is disqualified from a governmental decision if (1) the official, or the official's sole proprietorship, has received \$500 from the source in the prior 12 months and (2) it is reasonably foreseeable the decision will have a material effect on the source. The analysis is comparable for any other

business entity in which the official has a 10-percent or greater interest with the caveat that the income allocated to the official from any particular source is determined by the official's pro rata share of the income. For example, if the official owns a 20-percent interest in a business, the official is potentially disqualified from a decision only if the gross receipts from the source to the business are \$2,500 or more.

### *Reporting*

In addition to disqualification, the Act requires the reporting of interests in business entities and sources of income, which serves as a mechanism to remind officials of potential disqualification and provides public oversight of official in the decision-making process. Reporting is required under Articles 2 and 3 of the Act. (Section 87200 *et seq.*)

For an interest in a business entity, the official must report (1) a statement of the nature of the investment, (2) the name of the business entity, (3) a statement of the fair market value of the investment, and (4) in some instances the date on which the interest was acquired or disposed. (Section 87206; also see Section 87302(b).) If the official holds a business position in the entity such as director, officer, partner, trustee, employee, or manager, the official must also identify the position. (Section 87207; also see Section 87302(b).)

In addition to separately reporting the business entity in which the official has an interest, an official may also be required to report income received from the business entity as well as income received from the customers or clients of the business entity. However, the reporting thresholds for reporting income depend on whether the income is received directly by the official from the business entity or indirectly from a customer or client through the business entity.

For income received directly by an official, the official must report:

“(1) The name and street address of each source of income aggregating five hundred dollars (\$500) or more in value, or fifty dollars (\$50) or more in value if the income was a gift, and a general description of the business activity, if any, of each source.

“(2) A statement whether the aggregate value of income from each source, or in the case of a loan, the highest amount owed to each source, was at least five hundred dollars (\$500) but did not exceed one thousand dollars (\$1,000), whether it was in excess of one thousand dollars (\$1,000) but was not greater than ten thousand dollars (\$10,000), whether it was greater than ten thousand dollars (\$10,000) but not greater than one hundred thousand dollars (\$100,000), or whether it was greater than one hundred thousand dollars (\$100,000).

“(3) A description of the consideration, if any, for which the income was received.

“(4) In the case of a gift, the amount and the date on which the gift was received and the travel destination for purposes of a gift that is a travel payment, advance, or reimbursement.

“(5) In the case of a loan, the annual interest rate, the security, if any, given for the loan, and the term of the loan. (Section 87207(a); also see Section 87302(b).)

However, when income is received by a business entity the official must report:

“(1) The name, street address, and a general description of the business activity of the business entity.

“(2) The name of every person from whom the business entity received payments if the filer’s pro rata share of gross receipts from that person was equal to or greater than ten thousand dollars (\$10,000) during a calendar year.” (Section 87207(b); also see section 87302(b).)

The key distinction for purposes of this discussion is that the statute requires reporting income directly received by an official at a \$500 threshold. However, where income is received from a source through a business entity the official must only report the source of the official’s pro rata share if the gross receipts from the source is \$10,000 or more. Note, however, an official that must report income received through a business entity must also report the actual business entity as source of income pursuant to the \$500 threshold for income directly received.

In discussing the reporting thresholds for income received through a business in comparison to income directly received by the official, it is important to consider that the reporting scheme was intended to allow public oversight of an official in the decision-making process. Section 81002 of the Act establishes that one of the primary purposes of the Act is that:

“(c) Assets and income of public officials which may be materially affected by their official actions should be disclosed and in appropriate circumstances the officials should be disqualified from acting in order that conflicts of interest may be avoided.”

Nevertheless, the reporting scheme must also strike a balance between this purpose and the burden of compliance. It is apparent that the increased threshold for reporting sources of income to a business entity is intended to ease this burden. From a practical reporting standpoint, many businesses operate at a volume that would require tedious levels of reporting if an official were required to report sources of income to the business at a \$500 threshold.