

SUMMARY ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Chavez Analyst: Jeff Garnier Bill Number: AB 1338

Related Bills: See Prior Analysis Telephone: 845-5322 Amended Date: June 26, 2003

Attorney: Patrick Kusiak Sponsor: _____

SUBJECT: Withholding on California Real Estate to 9.3%

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended _____.

FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO _____.

REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED

June 12, 2003 STILL APPLIES.

OTHER - See comments below.

SUMMARY

This bill would:

- Modify the real estate withholding provisions to more closely match the actual tax due on the sale of real property,
- Broaden the principal residence withholding exemption to include the sale of a residence that was last used prior to the sale as the taxpayer's principal residence, and
- Exempt from withholding the sale of real property sold by licensed general contractors if the property was held for sale as inventory in the taxpayer's construction business.

SUMMARY OF AMENDMENTS

The June 26, 2003, amendments:

- Require the Franchise Tax Board (FTB) to develop a computer fillable withholding form that would enable the seller of real property to estimate the amount of taxable gain on the sale of the real property. The fillable form would be required to be posted on the FTB's website and to be capable of being filed electronically. Additionally, the fillable withholding form must state that the real estate escrow person (REEP) is prohibited from completing the form for a seller or assisting a seller in completing the form.
- Require the REEP to withhold on all transfers of real estate by individuals when the REEP fails to inform the buyer of California's real estate withholding requirements.
- Require the maximum withholding amount of 3^{1/30}% of the actual cash received by the seller in a failed like-kind exchange.

Board Position:

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Legislative Director

Date

Brian Putler

07/18/03

- Add a provision that relieves the REEP from the failure to withhold penalty if the seller timely pays the tax due from the disposition of the property.
- Make numerous other non-substantial technical changes.

The remainder of the analysis of the bill as amended on June 12, 2003, still applies.

IMPLEMENTATION CONSIDERATIONS

This bill would allow the seller to elect to have either 3^{1/3}% of the sales price or the highest applicable marginal rate (9.3%, 8.84%, or 10.84%) of the gain from the transfer. Much of the revenue loss associated with this bill is from sellers electing to have withholding based on the highest applicable rate of the actual gain. The seller electing the highest rate on actual gain option would be required to provide a written certificate, executed under penalty of perjury, specifying the amount of the taxable gain from the transfer of the property. The bill is silent on how this aspect is to be administered. Department staff, with industry input, have developed simplified procedures. The seller will provide the amount to be withheld to the REEP on the signed written certificate. Prior to the June 26, 2003, amendment, the calculation of the gain would only be provided to the FTB upon request.

The June 26, 2003, amendments would require the department to allow the form to be filed electronically. Based on this amendment, the department believes that numerous sellers will file the completed form electronically and/or in paper form without being requested to do so by the FTB. Under present law, the withholding form is not required to be filed, it is only required to be provided to the department upon request. This amendment arguably creates a filing requirement and would require the department to develop and maintain an electronic and a paper filing system that was not required under the prior version of this bill.

The written certificate provided by the seller to change the withholding to 9.3% of the gain must be signed by the seller under penalty of perjury. The amendment providing for electronically filed certificates would create procedural problems for the department. Neither the department nor the Internal Revenue Service has formally adopted procedures for the acceptance of electronic signatures. This issue was addressed in AB 2979 (Assembly Revenue and Taxation Committee, 2002, as introduced February 27, 2002). The provision was removed from the bill and was not enacted into law.

Additionally, the June 26, 2003, amendments would require the form to state that California law prohibits title and escrow companies, real estate licensees, and exchange accommodators from giving legal or accounting advice in the preparation of the form. Other than what is stated to be included in the form, California law does not prohibit or encourage a REEP from assisting in the preparation of the form. If this June 26, 2003, amendment is determined to prohibit the REEP from giving advice, the bill fails to state what the consequence is if a REEP commits a prohibited act.

TECHNICAL CONSIDERATIONS

The June 26, 2003, amendments struck the phrase "real estate escrow person" from several key provisions resulting in the REEP being required to withhold on all sales by individuals. The REEP would not be allowed to permit a seller to take advantage of exemptions from or reductions in withholding such as the sale of a principal residence or property sold at a loss. This is not consistent with the intent of the bill.

On page five, line 2, the June 26, 2003, amendment recommends the seller to "contract" an attorney when it should read "contact" and attorney.

FISCAL IMPACT

The department estimates that it would cost \$310,000 in the first year and \$200,000 every year thereafter to develop and maintain an electronic and paper filing system

ECONOMIC IMPACT

Tax Cash-Flow Estimate:

This bill would result in cash-flow losses as follows:

Estimated Cash-Flow* Impact of AB 1338 As Proposed to be Amended June 26, 2003 Effective for tax years BOA 1/1/2003 Enacted after 6/30/2003 \$ Millions			
	2003-04	2004-05	2005-06
1. 3.3% W/H or 9.3% on Gains	-\$30	-\$3	-\$3
2. Exempt Select. Residences	-\$1	Minor loss	Minor loss
3. Exempt Schedule C General Contractors	-\$1	Minor loss	Minor loss
4. Exempt Withholding on Failed Exchanges	-\$2	Minor loss	Minor loss
Total	-\$34	-\$3	-\$3

* Ultimate tax liabilities are not affected, only the timing of payments.

+ Less than \$250,000.

Cash-flow Estimate Discussion

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

This bill is expected to affect only the timing of payments, not ultimate tax liabilities.

For the first provision, the cash-flow impact for the first item was estimated as follows. The cash flow reductions due to withholding at the lower of 3.3% of the sales price or 9.3% of net capital gains were estimated based on the department's 1999 and 2000 capital gains samples. The 1999 and 2000 reductions were extrapolated to 2003 using projected growth rates of residential sales. The cash-flow impact is estimated as the average of these two cash-flow losses.

The second provision to exempt from withholding on selected personal residences was derived as follows. First, the sales of the residences that do not meet the two-year live-in requirement of a principal residence in 2000 were estimated using the department's personal income tax sample. Next, the sales of second and vacation homes were estimated. These sales amounts are extrapolated to 2004 based on the projection of real estate growth. The gross cash-flow reduction is estimated as 3.3% of the qualified sales. This gross amount is adjusted downward for the qualifying amount, fiscal year differences, offsetting estimate/withholding payments under current law, and other prepayments.

The third provision to exempt from withholding Schedule-C general contractor was derived as follows. First, the gross receipts of all sole proprietors with North American Industry Classification System (NAICS) Code of 233200 (residential building construction) in 2000 were estimated using the department's personal income tax sample. This amount is extrapolated to 2004 based on projection of real estate growth. The gross cash-flow reduction is estimated as 3.3% of the qualified amount. This gross amount is adjusted downward for qualifying amount, fiscal year differences, offsetting estimate payments under current law, and other prepayments.

The fourth provision's tax impact is estimated as follow. An estimate was received from an industry source that the value of 1031 exchanges nationally is between \$250 billion and \$500 billion. The lower bound if this estimated range of \$250 billion was used. An assumption that 10% of the national value pertained to exchanges of California property was made. Next, based on an estimate from the same industry source, 10% of the value of 1031 exchanges pertains to failed exchanges. This results in \$2.5 billion of failed 1031 exchanges in California.

Next it was estimated that only 20% of these exchanges are transacted by individuals and certain corporations, and, thus, would affect the withholding provision. Therefore, the lower bound estimate of the total value of failed 1031 exchanges affected by this provision is \$500 million. Assuming an average withholding rate of 2% (some taxpayers using the statutory 3.3% rate on sales price and others using the optional 9.3% rate on gains) yields a total value of withholding of \$10 million. It is estimated that this \$10 million in reduced withholding would generate a net cash-flow loss of \$2 million in FY 2003-04. Since the lower bound estimates were used in this calculation, the actual revenue loss is likely to be greater than \$2 million.

The cash-flow impact of AB1338 for fiscal year 2003/04 is estimated to be a cash-flow loss of \$34 million. This cash-flow loss is largely a one-time event. The term "cash-flow" loss means that while ultimate tax liabilities are not changed, the timing of tax payments through withholding relative to current law by this bill will be affected.

POLICY CONSIDERATIONS

The policy considerations presented in the bill analysis as amended February 21, 2003, are being repeated here for convenience. One policy concern has been revised as noted below.

Revised considerations:

- The June 26, 2003, amendments added a provision that would eliminate liability of the REEP for a penalty for failure to withhold if the seller timely pays the tax on the transaction. Adding this provision makes the liability for the penalty different for the REEP and the buyer. Under present law the buyer remains liable for the penalty to properly withhold even if the seller reports the gain and timely pays the proper amount of tax. Many of the buyers affected by real estate withholding are purchasing their personal residence and have no other need to understand withholding. The REEP (usually an escrow company) is better equipped to handle the withholding. The elimination of the penalty for the REEP alone appears not only inequitable, but it defeats the purpose of a penalty. Penalties are generally enacted and assessed to assure future compliance. Making the penalty not assessable until up to 22 months after the transaction (e.g., property sold in January of 2004 and the return is filed in October of 2005) and dependent on the actions of another party (the seller must report the gain and pay the tax, not the REEP) does not compel future compliance.

In addition, this provision conceptually deviates from the federal law withholding provisions on nonresident aliens and foreign corporations that specifically require the withholding agent (not necessarily the buyer) to be responsible for the withholding and remitting. Federal law does not permit the waiver of a penalty for a withholding agent if the seller timely paid the proper amount of tax on the transaction. Under federal law, the basic definition of a withholding agent is the person in control of payment. In most cases this would be the REEP.

Continuing consideration:

- Allowing the taxpayer to elect between $3\frac{1}{3}\%$ of the sales price or the highest marginal rate of the actual gain will virtually eliminate over-withholding of taxes.
- Revising the withholding requirements on certain corporations to match the individual requirements and eliminating the corporate waiver process lessens the burden on both the taxpayer and the department by having only one set of rules.

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