

BILL ANALYSIS

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Department, Board, Or Commission	Author	Bill Number
Franchise Tax Board	Laird	ABX3 36

SUBJECT

Increase Withholding/Accelerate Estimate Payments/Remove Safe Harbor Provisions for Taxpayers With Income Over \$1 Million

SUMMARY

This bill would do the following:

- Increase amounts required to be withheld from wages for taxes,
- Accelerate required estimate payments, and
- Remove the option for taxpayers with specified income thresholds to use their prior year's tax amount for required estimate payments.

PURPOSE OF BILL

The purpose of the bill is to address the fiscal emergency, which is the reason for the special session.

EFFECTIVE/OPERATIVE DATE

This bill would be effective on the 91st day after adjournment of the third special session and operative for taxable years beginning on and after January 1, 2009.

ANALYSIS

FEDERAL/STATE LAW

On an annual basis, the Franchise Tax Board (FTB) is required to provide the Employment Development Department (EDD) with wage withholding tables to be used by employers to withhold taxes on wages paid to their employees. The tables are based on the estimated amount of tax due on the wages paid by the employer. In addition, employers required to withhold tax on supplemental wages can use a method that applies a fixed rate to the supplemental wage amount. This rate is 6% for supplemental wages other than stock options and bonus payments. The rate of withholding for stock options and bonus payments is 9.3%. Taxpayers are required to make estimate payments if the amount of taxes withheld or otherwise available for a taxable year is less than the amount due.

In general, individual and corporate taxpayers are required to remit four estimated tax payments each equal to 25% of the required annual payment. Current federal and state tax law provides two options in determining the required annual payment for personal income taxes (PIT).

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The required annual payment for an individual subject to the personal income tax is the lesser of the following:

- Option 1: 90% of the tax shown on the return for the taxable year, or
- Option 2: 100% of the tax shown on the return of the taxpayer for the prior taxable year.

Option 2 would not apply if the prior tax year was not a complete taxable year of 12 months or if the taxpayer failed to file a return for the prior tax year.

Current federal and state tax law increases the required annual payment under option 2 from 100% to 110% of the tax shown on the return if the adjusted gross income (AGI) of the taxpayer for the prior year exceeds \$150,000 (\$75,000 in the case of a married individual filing a separate return).

Current federal law generally provides two options in determining the required annual payment for corporate income taxes. The required annual payment for corporations is the lesser of the following:

- Option 1: 100% of the tax shown on the return for the taxable year, or
- Option 2: 100% of the tax shown on the return for the preceding taxable year.

In general, current state law requires corporations to remit four estimated tax payments totaling 100% of tax shown on the return for the taxable year. If a corporation's estimated tax does not exceed the minimum franchise tax, the entire amount of the minimum franchise tax is payable as the 1st estimated tax payment. If the amount of estimated tax exceeds the minimum franchise tax after the last day of the 3rd month and before the 1st day of the 6th month of the corporation's taxable year, the amount of the 2nd, 3rd, and 4th estimated tax payments each equal 33 1/3% of the total estimated tax.

THIS BILL

This bill would require FTB to prepare withholding tables to withhold an amount that is 10% higher than the amounts estimated to be due on the wage earned under current law for taxable years beginning on or after January 1, 2009. This bill would increase the fixed rate of tax withheld from supplemental wages from 6% to 6.6%, and would increase the fixed rate withheld from stock options and bonus payments from 9.3% to 10.23%.

For taxable years beginning on or after January 1, 2009, this bill would revise the required quarterly installments of estimated tax payments from four equal payments to the following:

- 1st quarter installment- 30% of estimated tax
- 2nd quarter installment- 30% of estimated tax
- 3rd quarter installment- 20% of estimated tax
- 4th quarter installment- 20% of estimated tax

This bill would require corporate taxpayers who are not required to make an estimate payment installment in the first quarter to make the following installment payments in subsequent quarters:

- 2nd quarter installment- 40% of estimated tax
- 3rd quarter installment- 30% of estimated tax
- 4th quarter installment- 30% of estimated tax.

This bill would also eliminate the option for taxpayers to make estimate payments equal to 100% of the tax shown on the return of the taxpayer for the prior taxable year if the AGI of taxpayer shown on the return in the preceding taxable year exceeds \$1 million, or \$500,000 for taxpayers with a married filing separate filing status.

LEGISLATIVE HISTORY

AB 2065 (Oropeza, Stats. 2002, Ch. 488) authorized 9.3% withholding on stock options and bonus payments in lieu of the withholding tables or supplemental income withholding rates.

AB 1843 (Ackerman, Stats. 2000, Ch. 862) revised references to income year to taxable year for the calculation of tax and required estimate payments.

FISCAL IMPACT

Implementing this bill would not significantly impact the department program or operations.

ECONOMIC IMPACT

Based on data and assumptions discussed below, this bill would result in the following annual revenue gains beginning in fiscal year 2008/09.

Estimated Revenue Impact of ABX3-36 Effective for Tax Years BOA January 1, 2009 (\$ Millions)			
Item	2008/09	2009/10	2010/11
Provision A – increase withholding to 110%	\$1,560	\$45	\$45
Provision B – eliminate estimated payment “safe harbor” if AGI \$1 million or more	\$405	\$50	\$25
Provision C – change in estimated payment amounts	\$1,270	\$240	\$165
Interaction of provision B&C	\$60	\$10	\$10

The revenue impact of each provision included in this bill was estimated as if each were independent of any other provision. However, if enacted together, provisions B and C interact with each other and increase the revenue estimate for the bill as a whole. The interaction is estimated at \$60 million in fiscal year 2008/09, \$10 million for fiscal year 2009/10, and \$10 million for 2010/11.

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

Revenue Discussion

The revenue impact for Provision A is based on an analysis of departmental data on total withholding. Because this provision would not affect withholding on pensions, which is done only at the request and at the amount requested by the pension recipient, withholding amounts that we estimate to be attributed to pensions are excluded. We estimate that there was approximately \$28 billion of withholding in 2005. Increasing this withholding by 10% yields \$2.8 billion ($\$28 \text{ billion} \times 10\%$). We assume that some taxpayers will change their withholding in response to this increase in withholding. Ultimately, approximately 18% of new withholding will be offset by taxpayer behavioral changes. This change, however, will take three years to phase in. It is further assumed that the percentage behavioral offset would be largest for high income taxpayers. In the first year, the net behavioral decrease is estimated to be 14%. This leaves approximately \$2.4 billion in new withholding in the first year [$\$2.8 \text{ billion} \times (100\% - 14\% \text{ behavior})$]. This withholding is then grown from 2005 levels to 2009 levels by the Department of Finance's (DOF) projection of withholding growth, or 19% to approximately \$2.9 billion ($\$2.4 \text{ billion} \times 119\% \approx \2.9 billion). Assuming half of this new withholding will take place in January through June and result in an acceleration of revenue into the 2008/09 fiscal year, the first year revenue impact is one-half of the \$2.9 billion or \$1.45 billion. We then add in an estimated \$110 million in new accrued withholding revenue for a 2008/09 estimate of \$1.56 billion. In subsequent years, the same process is used for estimating the amount of accelerated withholding, and then the amount that was accelerated in the prior year is subtracted to arrive at the net revenue gain from increased withholding.

The revenue impact for Provision B is based on data on large payments in April, 2007. The DOF revenue forecast suggests that April payments in 2010 will be similar to the level of payments in April, 2007. It was estimated from this data that \$2.5 billion in large April payments were coming from taxpayers who were relying on the 110% prior year "safe harbor" for estimated payments and who had income greater than \$1 million. It was assumed that 75% of these taxpayers would adjust their payment patterns to avoid an estimated tax penalty. Therefore, there would be approximately \$1.9 billion in final payments under current law that would become estimated payments under this proposal ($\$2.5 \text{ billion} \times 75\% \approx \1.9). One-half of this would be paid in the first two estimated payments and thus create an acceleration of revenue into fiscal year 2008/09. The first year revenue number is \$950 million ($\$1.9 \text{ billion} \times 50\%$). Payments from estates and trusts, who are exempt from this law change, are then subtracted and the revenue impact drops to \$900 million in fiscal year 2008/09.

Based on a review of large income tax payments, that amount is reduced by 55% to account for those taxpayers whose AGI was less than \$1 million in the prior year. [$\$900 \text{ million} - (\$900 \text{ million} \times 55\%) = \405 million]

In subsequent years, we calculate, in a similar fashion, the revenue accelerated because of increased estimated payments. For each subsequent year, the decrease in payments due to the payments that had been accelerated to the prior year is subtracted.

The revenue impact for Provision C is based on data for estimated tax payments that are forecast to be made from February through June of 2009 for PIT taxpayers, and the estimated payments that are forecast to be made in April and June of 2009 for corporate taxpayers. These estimated payments total \$8.4 billion. The increase of the estimated payment rate from 25% of annual tax to 30% of annual tax represents an increase of 20%. Thus, the additional estimated payments in the first six months of 2009, assuming taxpayers fully comply with this provision are expected to be \$1.7 billion ($\$8.4 \text{ billion} \times 20\% \approx \1.7 billion). It is assumed that compliance would be 75% in the first year. Therefore the new revenue in fiscal year 2008/09 would be about \$1.27 billion ($\$1.7 \text{ billion} \times 75\% \approx \1.27 billion). In subsequent years, the calculation is made in a similar fashion; the revenue is accelerated because of increased estimated payments. For each subsequent year, the decrease in payments due to the payments that had been accelerated to the prior year is subtracted.

Appointments

None.

Support/Opposition

According to the Senate Floor analysis of September 15, 2009, no support or opposition was received.

VOTES

Assembly Floor – Ayes: 43, Noes: 29

Senate Floor – Ayes: 21, Noes: 18

LEGISLATIVE STAFF CONTACT

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