ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author:	Ma	Analyst:	William Koch	Bill Number:	AB 1848
Related Bills:	None	Telephone:	845-4372	Introduced Date:	January 28, 2008
		Attorney:	Douglas Powers	Sponsor:	Franchise Tax Board

SUBJECT: Conformity To Federal Backup Withholding

SUMMARY

This bill would require withholding on certain payments whenever such payments are subject to federal backup withholding.

PURPOSE OF THE BILL

The purpose of this Franchise Tax Board (FTB) sponsored bill is to require California income tax withholding on certain payments that may otherwise go unreported, thus narrowing the tax gap.

EFFECTIVE/OPERATIVE DATE

This bill would be effective January 1, 2009, and specifically operative for payments made on or after that date.

POSITION

Support.

On November 28, 2007, the FTB voted 2-0, with the Department of Finance abstaining, to sponsor the language included in this bill.

ANALYSIS

CURRENT FEDERAL LAW

Banks and other businesses that make payments of the type that are required to be reported on an information return— i.e., Form 1099 series—may be required to backup withhold on those payments. A payee is required to provide a correct taxpayer identification number (TIN) to the payer who must report that information on the applicable Form 1099.

Board Position:			Department Director	Date
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Payments subject to backup withholding include interest (Form 1099-INT); dividends (1099-DIV); certain patronage dividends (1099-PATR); rents, profits, or other gains (Form 1099-MISC); commissions, fees, or other payments to independent contractors (1099-MISC); payments by brokers (1099-B); certain payments by fishing boat operators (1099-MISC); royalty payments (1099-MISC); and certain gambling winnings (W-2G). Payments that are excluded from federal backup withholding include, among other things, real estate transactions, unemployment compensation, and state or local income tax refunds.

Payments to the payee will be subject to backup withholding at a rate of 28% in the following situations:

- Payee does not give the payer his or her TIN in the required manner.
- The IRS notifies the payer that the TIN payee gave was incorrect.
- Payee is required, but fails, to certify that he or she is not subject to withholding.
- The IRS notifies the payer to start withholding on interest or dividends because the payee has underreported interest or dividends on his or her federal income tax return. The IRS will do this only after it has mailed the payee four notices over at least a 210-day period.

Federal law provides civil and criminal penalties for giving false information to avoid backup withholding. This civil penalty is $500. The criminal penalty, upon conviction, is a fine of up to $1,000 or imprisonment of up to one year, or both.

CURRENT STATE LAW

California does not conform to federal backup withholding provisions.

THIS BILL

This bill would require the social security number or other taxpayer identification number of the recipient of income to be furnished upon demand by the person paying the income.

For payments made on or after January 1, 2009, this bill would conform California tax law to the federal backup withholding regime to require such withholding at a rate of 7% for California purposes whenever it is required for federal purposes.

The bill defines “reportable payment” by reference to Section 3406(b) of the Internal Revenue Code and should include only payments of items of income as defined in Section 18662 of the Revenue and Taxation Code and applicable regulations.

The withholding provisions of this bill would supersede any other provision of Article 5 of Chapter 2 of Part 10.2 of the Revenue and Taxation Code that would otherwise require withholding.

The bill would require that any payer required to withhold tax pursuant to this provision should notify the payee of such withholding at a time and manner as prescribed in forms and instructions issued by the FTB.

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.

Program Background

The California tax gap is estimated to be approximately $6.5 billion per year. Almost 80% of the tax gap is attributable to underreporting of income or overreporting of deductions, primarily by individuals. Studies conducted by the IRS indicate that taxpayers voluntarily report 96% of income that is subject to information reporting. That rate increases to 99% when the income is subject to withholding.

Current federal and California law requires business payers to file with the government and payees information returns on many types of payments that generally produce taxable income. The federal Form 1099 series is used to report various types of income such as nonemployee compensation, interest and dividends, or brokerage proceeds. Information reporting is effective at improving compliance because the information is shared with the government and this reporting encourages taxpayers to include this reported income on their voluntarily filed returns. The effectiveness of information returns as a compliance tool is compromised if the information cannot be successfully linked to the correct taxpayer because of bad or missing taxpayer identification numbers (TINs).

To address the problem of bad or missing TINs, federal law requires backup withholding—that is, withholding at the time and source of payment—at a rate of 28% on certain payments if the payee fails to furnish a TIN to the payer or the payer is notified by the IRS that the provided TIN is incorrect. Backup withholding also applies to interest and dividend payments if the taxpayer has previously underreported such payments.

Payers are instructed to use federal Form W-9, Request for Taxpayer Identification Number and Certification, to request a payee's TIN. A TIN is usually a federal employer identification number (FEIN) or social security number (SSN). In general, the TIN used for information reporting for IRS purposes is accepted by the FTB. However, California state agencies are required to use Standard Form 204, Payee Data Record, to request a service-provider's (i.e., payee's) TIN and the service-provider must provide a correct TIN in order to do business with the State of California. For this purpose, the appropriate TIN for an individual or sole proprietor is their SSN.

The FTB currently administers a withhold-at-source program on payments to nonresidents for services performed by independent contractors, rents, royalties, estate distributions, trust distributions, and partnership distributions and allocations of income. Withholding, generally at a rate of 7%, is required when payments to a nonresident exceed a threshold amount. The FTB also administers withholding on sales of California real estate by residents and nonresidents. California does not have a backup withholding program.

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.

Minnesota law follows the federal provisions for backup withholding on payments for personal services only. The amount withheld is determined by applying the highest individual income tax rate, currently 7.85%. In addition, if an entertainment entity fails to provide the payer with a TIN, the payer must withhold at the backup rate of 8.5%. Corporations are exempt from backup withholding.

Illinois law expressly states that no withholding is required on payments subject to federal backup withholding.

Review of the laws of *Florida*, *Massachusetts*, *Michigan*, and *New York* did not reveal any backup withholding requirements.

FISCAL IMPACT

Annual costs to administer and process backup withholding remitted to the department are expected to be minor and would be absorbed by the withhold-at-source business area. Annual costs to process tax returns claiming backup withholding credits and to respond to taxpayer contacts would be approximately $200,000, which would be acquired during our normal budgetary process.

ECONOMIC IMPACT

Revenue Estimate

This bill would result in the following revenue gain:

Estimated Revenue Impact Effective 1/1/2009 Enacted by 6/1/2008 ($ in Millions)			
2008/09	2009/10	2010/11	2011/12
+$35	+$35	+$35	+$40

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

Revenue Discussion

The above revenue impact was estimated in three steps. First, federal backup withholding amounts were estimated based on the federal total tax withheld on taxpayers with California addresses as reported on IRS forms 1099-B, 1099-DIV, 1099-INT, 1099-MISC, 1099-OID, 1099-PATR, and W-2G.

It was assumed that: (1) 50% of the tax reported as withheld on form 1099-MISC, (2) 75% of the amount reported as withheld on form W-2G, and (3) 100% of the tax reported as withheld on the remaining forms represent federal backup withholding. It was estimated that about $543 million of federal backup withholding was withheld on 376,000 taxpayers with California addresses in 2005.

Next, the California backup withholding amount was estimated. Because California does not have jurisdiction over out-of-state banks, brokers, and firms that do not have nexus with this state, not all payments subject to federal backup withholding would be subject to California backup withholding. The assumed percentages of federal backup withholding that would be subject to California backup withholding vary by tax forms, ranging from 20% for forms 1099-B and 1099-DIV to 75% for form 1099-MISC. In addition, the estimates were adjusted to reflect the proposed California backup withholding rate of 7% versus the federal rate of 28%. It was estimated that approximately $74 million of backup withholding would be withheld on 143,000 California taxpayers in 2005.

Finally, the estimated California backup withholding amount was adjusted to discount for: (1) the amount of tax that taxpayers would have paid anyway under current law (assumed to be 50%), and (2) the refunds due to over-withholding that would occur under this bill (assumed to be 12%). The net impact of the proposed California backup withholding program was then extrapolated to later years. The extrapolation was based upon the latest Department of Finance forecast for corporate profits. For the 2009 tax year, California backup withholding was estimated to be $85 million. The amount of tax that taxpayers would have paid anyway under current law was estimated to be $42 million. The refunds due to over-withholding were estimated to be $11 million.

The extrapolated results on a tax-year basis were then converted to a fiscal-year basis. For example, it was estimated that only $44 million of the 2009 backup withholding, $9 million of the amount of tax that taxpayers would have paid anyway under current law, and none of the 2009 refunds due to over-withholding would occur in the 2008/2009 fiscal year. The result is an estimated net revenue gain of $35 million from approximately 76,000 taxpayers. ($44m − $9m = $35m). Similarly, for the 2009/10 fiscal year, it was estimated that $87 million would be withheld under this proposal. This amount was reduced by $9 million in refunds of amounts withheld under this proposal and $42 million that would have been otherwise collected under current law, resulting in a net revenue gain of $35 million from approximately 145,000 taxpayers. ($87m − ($9m + $43m) = $35m). Similar calculations were performed for subsequent years.

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