

# ANALYSIS OF AMENDED BILL

## Franchise Tax Board

Author: Committee on Budget Analyst: William Koch Bill Number: ABX4 18  
Related Bills: See Legislative History Telephone: 845-4372 Amended Date: July 23, 2009  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Backup Withholding

### SUMMARY

This analysis does not address provisions of the bill that are related to the sales and use tax laws.

This bill would conform, with modifications, to the federal backup withholding regime.

### SUMMARY OF AMENDMENTS

This bill as introduced July 2, 2009, expressed the intent of the Legislature to enact changes to the Budget Act of 2009.

The July 23, 2009, amendments removed the intent language and added the provisions discussed in this analysis.

This is the department's first analysis of this bill.

### PURPOSE OF THE BILL

It appears the purpose of this bill is to accelerate revenue and increase tax compliance to address the fiscal emergency declared by the Governor by proclamation on July 1, 2009.

### EFFECTIVE/OPERATIVE DATE

As a special session bill, this bill would become effective on the 91st day after adjournment of the special session, and would be operative as of that date. Backup withholding is specifically operative for payments made on or after January 1, 2010.

### POSITION

Support.

On November 28, 2007, the three-member Franchise Tax Board (FTB) voted 2-0, with the Department of Finance abstaining, to sponsor the backup withholding provisions contained in this bill.

#### Board Position:

S      \_\_\_\_\_ NA      \_\_\_\_\_ NP  
\_\_\_\_\_ SA      \_\_\_\_\_ O      \_\_\_\_\_ NAR  
\_\_\_\_\_ N      \_\_\_\_\_ OUA      \_\_\_\_\_ PENDING

Department Director

Date

Lisa Crowe

08/21/09

For Selvi Stanislaus

## **ANALYSIS**

### FEDERAL/STATE LAW

#### 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.

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 percent 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 “reportable payments” made on or after January 1, 2010, this bill would conform, with modifications, California tax law to the federal backup withholding regime to require such withholding at a rate of 7 percent for California purposes.

The bill defines “reportable payment” by reference to Section 3406(b) of the Internal Revenue Code and includes payments of income as defined in Section 18662 of the Revenue and Taxation Code and applicable regulations, with respect to rents, prizes and winnings, compensation for services, including bonuses, and other fixed or determinable annual or periodic gains, profits, and income.

The following payments of income would be specifically excluded from California backup withholding:

- Interest and dividends
- Any release of loan funds made by a financial institution in the normal course of business

This bill defines the term financial institution as:

- A depository institution, as defined in Section 1813(c) of Title 12 of the United States Code;
- An institution-affiliated party, as defined in Section 1813(u) of Title 12 of the United States Code; and
- Any Federal credit union or State credit union, as defined in Section 1752 of Title 12 of the United States Code, including an institution-affiliated party of such a credit union, as defined in Section 1786(r) of Title 12 of the United States Code.

California backup withholding would supersede any other withholding provision of Article 5 of Chapter 2 of Part 10.2 of the Revenue and Taxation Code that would otherwise require withholding.

This 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 department’s normal annual update.

### **LEGISLATIVE HISTORY**

ABX3 19 (Evans, 2009/2010) and SBX3 17 (Ducheny, 2009/2010), in addition to other unrelated provisions, contain provisions similar to this provision. ABX3 19 was approved by the Senate and Assembly on June 30, 2009, and July 1, 2009, respectively, but has yet to be enrolled and sent to the Governor. SBX3 17 was vetoed by the Governor on June 30, 2009. In his veto message, Governor Schwarzenegger stated, “I have been very clear that the Legislature must solve the entire deficit, must make the hard decisions now, and must not push the problem off to tomorrow. This bill and its companion measure, SBX3 16, do not meet any of those criteria.”

AB 1848 (Ma, 2007/2008) contained identical language as this bill. AB 1848 failed to pass out of the Senate.

## **PROGRAM BACKGROUND**

The California tax gap is estimated to be approximately \$6.5 billion per year. Almost 80 percent 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 percent of income that is subject to information reporting. That rate increases to 99 percent 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 percent 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 percent, 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 percent. 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 percent. 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**

First year implementation costs are estimated to be \$300,000. Annual costs to administer and process backup withholding remitted to the department, to process tax returns claiming backup withholding credits, and to respond to taxpayer contacts would be approximately \$500,000.

### **ECONOMIC IMPACT**

#### Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue gains.

Estimated Revenue Impact of Backup Withholding Effective for Payments Issued On or After 1/1/2010 Enactment assumed after 6/30/2009 \$ in Millions			
2009-10	2010-11	2011-12	2012-13
\$32	\$31	\$33	\$35

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 revenue impact was estimated as follows. First, federal backup withholding amounts were estimated from the federal data. The IRS provided data on total tax withheld from forms 1099-B, 1099-MISC, 1099-DIV, 1099-INT, 1099-OID, 1099-PATR, and W2-G from taxpayers with California addresses. Not all of the taxes withheld are backup withholding. It is assumed that 50 percent of the tax withheld on form 1099-MISC, 75 percent of the tax withheld on form W2-G, and 100 percent of the tax withheld on all remaining forms are for federal backup withholding purpose. It is 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 amounts were estimated because California does not have jurisdiction over out-of-state banks, brokers, and firms that do not have nexus in the state. Not all-federal backup withholding can be subject to California backup withholding. The assumed percentages of federal backup withholding that are subject to California backup withholding vary by tax forms, ranging from 20 percent for form 1099-B to 75 percent for form 1099-MISC. In addition, the estimates were adjusted to reflect the fact that the proposed California backup withholding rate of 7 percent is much lower than the federal rate of 28 percent. It is estimated that about \$74 million of backup withholding would have been withheld on 143,000 California taxpayers in 2005.

The estimated California backup withholding amount was adjusted downward to reflect (1) taxes that taxpayers would have paid anyway under current law (assumed to be 50 percent), (2) refunds due to over-withholding under this proposal (assumed to be 12 percent), and exclusion of interest and dividend income from backup withholding (assumed to be 6.6 percent). 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 personal income. For the 2010 tax year, the California backup withholding was estimated to be \$81 million. The amount of tax that taxpayers would have paid anyway under current law was estimated to be \$40 million. The refunds due to over-withholding was estimated to be \$10 million. Finally, the amounts were converted to a fiscal year basis.

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