

# ANALYSIS OF ORIGINAL BILL

Author: Stone Analyst: Diane Deatherage Bill Number: SB 495  
 See Legislative  
 Related Bills: History Telephone: 845-4783 Introduced Date: February 26, 2015  
 Attorney: Bruce Langston Sponsor \_\_\_\_\_

<b>SUBJECT:</b>	Withholding on California Real Property Not Required if Transferor Makes Election to Remit Tax Due with Filing Tax Return
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## SUMMARY

This bill would amend the withholding requirement relating to sales of real property under the Administration of Franchise and Income Tax Law.

## RECOMMENDATION

No position.

## REASON FOR THE BILL

The reason for the bill is to ease the burden for property transferors by allowing them to make an election to pay the capital gains tax when filing their California tax return, instead of paying the tax shortly after escrow closes.

## EFFECTIVE/OPERATIVE DATE

This bill would be effective January 1, 2016, and would be operative for a disposition of a California real property interest that occurs in taxable years beginning on or after January 1, 2016.

## FEDERAL/STATE LAW

Under federal law, a percentage of income paid to a nonresident alien or a foreign corporation for services or sale of real property must be withheld. The withholding obligation is imposed on the withholding agent. A withholding agent means the person that is normally responsible for the disbursement of the funds. The withholding agent is frequently the person paying for the services or purchasing the property, but can also be an attorney, escrow person, broker, or other intermediary.

A penalty is imposed if the withholding agent fails to withhold from a nonresident alien or foreign corporation. The amount of the federal penalty is equal to the amount of tax the taxpayer ultimately fails to pay, but cannot exceed the amount that should have been withheld. Therefore, the penalty can be assessed only once the Internal Revenue Service (IRS) determines the amount of tax the taxpayer failed to pay. The penalty is excused if the failure to withhold is due to reasonable cause.

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California law is similar to federal law except California law expands withholding to the sale of California real property by any individual. Real estate withholding is a prepayment of the income (or franchise) tax due on the gain from the sale of California real property.

For real property, California law requires withholding of 3 1/3 percent (.0333) of the total sale price of California real property. Alternatively, a transferor may elect to have withholding calculated as the amount equal to the gain on the sale of California property required to be recognized on the tax return, as certified under penalty of perjury by the transferor, multiplied by the rate specified.

Withholding is not required on sales or transfers of California real property when:

- The total sale price does not exceed \$100,000,
- The transferor is a bank acting as a fiduciary for a trust,
- The property is being foreclosed upon, or
- The transaction meets one of the following exemptions where the transferor must sign a written certification under penalty of perjury to be exempt from withholding:

Certifications which fully exempt the sale from withholding:

- The property qualifies as the transferor's principal residence within the meaning of Internal Revenue Code (IRC) section 121,
- The property was last used as the transferor's principal residence within the meaning of IRC Section 121 without regard to the two-year time period,
- The sale will result in a loss or zero gain for California tax purposes,
- The property is being compulsorily or involuntarily converted and the transferor intends to acquire property that is similar or related in service or use to qualify for nonrecognition of gain for California income tax purposes under IRC section 1033,
- The transfer qualifies for nonrecognition treatment under IRC section 351 (transfer to a corporation controlled by the transferor) or IRC section 721 (contribution to a partnership in exchange for a partnership interest),
- The transferor is a corporation (or a limited liability company (LLC) classified as a corporation for federal and California income tax purposes) that is either qualified through the California Secretary of State or has a permanent place of business in California,
- The transferor is a California partnership or a partnership qualified to do business in California (or an LLC that is classified as a partnership for federal and California income tax purposes and is not a single member LLC that is disregarded for federal and California income tax purposes),
- The transferor is a tax-exempt entity under California or federal law, or
- The transferor is an insurance company, individual retirement account, qualified pension/profit sharing plan, or charitable remainder trust.

Certifications that may partially or fully exempt the sale from withholding:

- The transfer qualifies as a simultaneous like-kind exchange within the meaning of IRC section 1031,
- The transfer qualifies as a deferred like-kind exchange within the meaning of IRC section 1031, or
- The transfer of the property is an installment sale where the transferee is required to withhold on the principal portion of each installment payment.

An exemption certificate from withholding does not eliminate the requirement to file a tax return and pay the tax due.

Current law specifies when and how amounts withheld must be reported and remitted to the Franchise Tax Board (FTB) and imposes a penalty for a failure to withhold that is equal to the greater of \$500 or 10 percent of the amount required to be withheld. The penalty may be abated if the failure to withhold is due to reasonable cause.

## **PROGRAM BACKGROUND**

Real estate withholding is a prepayment of the income or franchise tax due from sellers of California real property. The real estate withholding prepayment is due to the FTB by the 20<sup>th</sup> day of the month following the month escrow closes. The seller can claim the prepayment as a payment against the tax due on the return. Real estate withholding does not relieve sellers from the requirement to file a tax return. Even if the seller is exempt from the real estate withholding requirements, they may still owe California taxes and have a requirement to file a California tax return.

## **THIS BILL**

This bill would, in the case of any disposition of a California real property interest in taxable years beginning on or after January 1, 2016, if not otherwise exempt, provide that withholding is not required if a transferor makes a written election, in a form prescribed by the FTB, to remit any tax due with the filing of any required tax return.

## **IMPLEMENTATION CONSIDERATIONS**

The department has identified the following implementation concern. Department staff is available to work with the author's office to resolve this and other concerns that may be identified.

Although this bill would allow a transferor to avoid withholding on the gain from the sale of real property by making an election, the bill is silent on whether the election would eliminate the accrual of interest and the assessment of penalties relating to the timeliness of payments (i.e., underpayment of estimated tax penalty, late payment penalty, etc.) when a transferor makes the election.

## LEGISLATIVE HISTORY

AB 2962 (Benoit, Chapter 428, Statutes of 2006) allowed transferors of California real property to elect an alternative to the withholding requirement based on a percentage of the sale price, effective January 1, 2007. The election requires the transferor to certify the withholding amount in writing under penalty of perjury.

## 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. No statutes were found for these states where a withholding requirement is imposed on the sale of real property.

## FISCAL IMPACT

This bill would require a new form for a taxpayer to make an election. As a result, this bill would impact the department's printing, processing and storage costs for tax returns. As the bill continues to move through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

## ECONOMIC IMPACT

### Revenue Estimate

This bill would result in the following revenue loss:

Estimated Revenue Impact of SB 495 As Introduced February 26, 2015 Assumed Enactment After June 30, 2015 (\$ in Millions)		
2015-16	2016-17	2017-18
- \$500	- \$50	- \$39

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

### Revenue Discussion

Based on the FTB's real estate withholding data grown by projections of real estate growth, it is estimated that approximately \$1.3 billion in 2016 and \$1.4 billion in 2017 would be collected as real estate withholding absent the proposed election. For purposes of this estimate, it is assumed 85 percent of taxpayers would opt out of real property withholding each year. As a result, \$1.1 billion would not be withheld in 2016, but would be paid in 2017, and \$1.2 billion would not be withheld in 2017, but would be paid in 2018.

The bill does not change the tax due; it only changes the timing of tax payments. While \$1.1 billion in real estate withholding would shift from 2016 to 2017, in 2017 the \$1.1 billion revenue payment shift would be offset by the \$1.2 billion revenue no longer being withheld and shifted into 2018 for payment, resulting in a net \$100 million dollar loss in 2017. A small adjustment is made for taxpayer compliance issues and the resulting collection actions. Because the operative date would be January 1, 2016, the \$1.1 billion revenue effect for 2016 would partially fall in fiscal year 2015-16 (\$500 million loss). The remainder of the 2016 taxable year and part of taxable year 2017 would fall in 2016-17. The results are fiscalized to arrive at the amounts reflected in the table above.

## **SUPPORT/OPPOSITION**

Support: None provided.

Opposition: None provided.

## **ARGUMENTS**

Proponents: Some may say that allowing the transferor to elect to pay the tax due on a California property sale when the transferor's return is originally due, instead of requiring withholding at the time of sale, would provide additional flexibility.

Opponents: Some may argue that the transferor, after making the election, may decide against putting the amount of tax due on the gain from the sale aside saving it until the tax return is due; and therefore, be unable to pay the amount of tax due by the original due date of the tax return, subjecting them to additional interest and penalties.

## **POLICY CONCERNS**

Generally, withholding is required for payments made to and income received by nonresidents. By allowing a nonresident transferor who sells California property to elect out of withholding, there would be differing treatments of withholding for nonresidents. In addition, the collection of any unpaid tax could be more difficult.

## **LEGISLATIVE STAFF CONTACT**

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