

ANALYSIS OF AMENDED BILL

Author: Stone Analyst: Diane Deatherage Bill Number: SB 495
 See Legislative
 Related Bills: History Telephone: 845-4783 Amended Date: April 22, 2015
 Attorney: Bruce Langston Sponsor _____

SUBJECT:	Withholding on California Real Property for Nonresidents and Certain Corporations
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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.

Summary of Amendments

The April 22, 2015, amendments modified withholding requirements applicable to sales of California real property interests. The amendments resolved the implementation concern as discussed in the department’s analysis of the bill as introduced February 26, 2015. As a result of the amendments, the department has identified technical and policy considerations.

This analysis replaces the department’s analysis of the bill as introduced February 26, 2015.

REASON FOR THE BILL

The reason for the bill is to eliminate existing withholding requirements and instead, require withholding of 3½ percent of the sales price of the property if the property was either acquired from a person or corporation that no longer has a connection to the state.

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 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.

Board Position:	Executive Officer	Date									
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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.

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 $\frac{1}{3}$ percent (.0333) of the total sales 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 sales 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 20th 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 on or after January 1, 2016:

- Make inoperative the existing withholding requirements relating to the sale of real property interests, including the ability to elect an alternative to the withholding requirement based on a percentage of the sales price.
- If not otherwise exempt, require the transferee of a real property interest to withhold 3½ percent of the sales price of the property if the property was either acquired from a person, who is not a resident or who after the transfer of the real property would no longer be a resident of this state, or from a corporation, if after the transfer that corporation has no permanent place of business in this state. A corporation would have no permanent place of business in this state if all of the following apply:
 - It is not organized and existing under the laws of California.
 - It does not qualify with the office of the Secretary of State to transact business in California.
 - It does not maintain and staff a permanent office in California.

- Exempt partnerships from withholding requirements by specifically providing that a person excludes a partnership as determined in accordance with Subchapter K of Chapter 1 of Subtitle A of the IRC.

IMPLEMENTATION CONSIDERATIONS

Implementing this bill would not significantly impact the department's programs and operations.

TECHNICAL CONSIDERATIONS

This bill inadvertently excludes an intermediary or accommodator in a deferred exchange from the requirement to withhold. The bill should be amended to include clarifying language that specifies that the withholding requirements, in the case of property disposition by a person or corporation, on or after January 1, 2016, would apply to any intermediary or accommodator in a deferred exchange.

For clarity and internal consistency, it is recommend that line 16 on page 5 be amended to read "it is not qualified with the office of the Secretary of State."

The present withholding regime is dependent on two provisions working together: (1) imposition of withholding requirements¹ and (2) penalties relating to withholding provisions.² To maintain this relationship, the existing statute that provides language that must be included in written notification of withholding requirements should be amended.

LEGISLATIVE HISTORY

AB 3078 (Committee on Revenue and Taxation, Chapter 305, Statutes of 2008), among other things, requires non-California partnerships to be subject to withholding on California real property sales at a rate of 3½ percent of sales proceeds or 9.3 percent of gain.

AB 2962 (Benoit, Chapter 428, Statutes of 2006) allows 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. AB 2962 was implemented to correct over-withholding on the sale of California real property interests.

AB 1338 (Chávez, Chapter 528, Statutes of 2004) revised withholding requirements for corporations with no permanent place of business in California to conform to the withholding requirements for individual transferors, clarified that transfers of real property to controlled corporations and partnerships are contributions to capital, and excluded sales of a decedent's principal residence by estates from withholding.

¹ Revenue and Taxation Code (R&TC) section 18662.

² R&TC section 18668.

AB 2065 (Oropeza, Chapter 488, Statutes of 2002), among other things, expanded withholding requirements to residents and converted the waiver process into a self-certification process, effective January 1, 2003. Prior to AB 2065, the withholding requirements on the sale of California real property interests applied to nonresidents and corporations that have no permanent place of business in this state after the transfer.

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

The department's costs to implement this bill have yet to be determined. As the bill moves 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 Amended April 22, 2015 Assumed Enactment After June 30, 2015 (\$ in Millions)		
2015-16	2016-17	2017-18
- \$490	- \$47	- \$37

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 grown³ by projections of real estate growth, approximately \$1.3 billion in 2016 and \$1.4 billion in 2017 would be collected as real estate withholding under current law. Using zip code data from California real estate sales, it is estimated that 20 percent of sales are executed by nonresidents and thus would be subject to withholding of 3.333 percent. As a result, \$1.035 billion that would have been withheld on sales

³ Indexed using Department of Finance forecasts.

by residents, partnerships, and corporations with a California place of business under current law in 2016 would instead be paid in 2017, and \$1.125 billion that would have been withheld in 2017 would instead be paid in 2018.

The bill does not change the tax due; it only changes the timing of tax payments. While \$1.035 billion real estate withholding would shift from 2016 to 2017, in 2017 the \$1.125 billion revenue payment shift would be offset by the \$1.125 billion revenue no longer withheld and shifted into 2018 for payment, resulting in a net \$90 million dollar loss (\$1.035 billion – \$1.125 billion) 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 \$1.035 billion revenue effect for 2016 would partially fall in fiscal year 2015-16 (\$490 million loss). The remainder of the 2016 taxable year and part of taxable year 2017 will fall in 2016-17. The taxable year estimates are converted to fiscal year estimates, rounded to arrive at the amounts in the table above.

SUPPORT/OPPOSITION

Support: California Association of Realtors.⁴

Opposition: None provided.

ARGUMENTS

Proponents: Some may say that withholding at a standard rate of $3\frac{1}{3}$ percent of the sales price would improve compliance among nonresident individuals and corporations lacking presence in California.

Opponents: Some may argue that standard rate withholding could result in over-withholding that an election to use an alternate withholding method would resolve.

POLICY CONCERNS

This bill would eliminate the withholding requirement on partnerships upon the disposition of California real property sales, yet keep the requirements for certain individuals and corporations. Thus, this bill would favor partnerships.

This bill would remove the existing provision, enacted to correct for over-withholding, that allows transferors to elect to compute withholding based on the gain from the sale instead of a percentage of the sales price. If this bill is enacted, the transferor would be unable to elect an alternate withholding computation that may more accurately reflect the tax due on the gain. For example, a transferor that sells a real property interest for \$300,000 that results in a gain of \$1 would be required to withholding $3\frac{1}{3}$ percent of the sales price, \$9,999 ($\$300,000 \times 3\frac{1}{3}\%$).

⁴ Senate Governance and Finance Committee Analysis, dated April 9, 2015.

Under prior law when withholding was computed at $3\frac{1}{3}$ percent of the sales price and there was no election to compute withholding using the alternative percentage based on the gain from the sale, the transferor could request the FTB for a waiver or reduced withholding. Although this bill would require withholding of $3\frac{1}{3}$ percent of the sales price without the option to make an election to use an alternative withholding computation, the bill fails to include a provision that would allow a transferor to request a waiver or reduced withholding. If this is contrary to the author's intent than the author intended, this bill should be amended.

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