

**Franchise Tax Board – Interested Parties Meeting
Topics of Discussion**

August 13, 2007

1. Overview and History of California Withholding at Source.

Withholding at source is an essential part of the department's Tax Gap compliance initiative. Withholding's "pay as you go" process helps taxpayers by ensuring that tax is collected as income is received. It helps the state by ensuring that tax is paid as it is incurred on specific transactions, encouraging taxpayers to file returns at the end of the year.

California law requires the Franchise Tax Board to issue regulations to implement the withholding at source statutory requirements (Revenue and Taxation Code (R&TC) section 18662, subdivision (a).) These regulations have not been updated in many years, and do not currently reflect statutory and other changes affecting the withholding statutes themselves. For example, statutory changes such as the addition of real estate withholding, statutory and other legal changes relating to residency and sourcing of income, and the use of different types of business entities, especially pass-through entities, have caused the regulations to need to be updated. They were written at a time when electronic filing and payment were not available, and also need to be updated to align these filing and payment procedures with modern practices.

The text of the existing regulations has been rewritten and reorganized into a simpler, more descriptive order. The revised text contains a Table of Contents, and the draft regulations begin with definitions and general rules applicable to all withholding at source, then provide specific guidance for the two major withholding areas that FTB administers: Real Estate Withholding, and Withholding on Payments (Nonresident Withholding). Withholding on Payments is then further broken down into the three major program areas currently addressed in FTB Publications: Non-Wage Independent Contractor, Rent and Royalty Guidelines (Pub. 1023); Entertainers and Athletes (Pub. 1024) and Pass-Through Entities (Pub. 1017). Reporting and Remitting Withholding rules have been consolidated into a single section. Finally, existing Regulation section 25410b would be renumbered as Regulation section 19002 and has been revised to add more specific rules for the crediting of withheld amounts.

In 1971, R&TC sections 18805 and 26131 (renumbered in 1993 to R&TC section 18662) were enacted to require "any person" to withhold on payments of California source income to nonresidents. The current version of the regulations under R&TC section 18662 are substantially similar to the 1971 regulations implementing the original withholding at source requirements.

In 1987, California conformed to federal law requiring withholding on partnership distributions to foreign (non-U.S.) partners and real property sales by certain foreign

sellers, setting the California withholding rate at one-third of the federal 10% rate for real estate and at the maximum personal income tax rate for distributions. In 1988, federal law changed the withholding on distributions to a requirement that withholding be remitted on the partner's distributive share of effectively connected (U.S. source) income, and California conformed to this change in 1989.

In 1990, California real estate withholding was extended to nonresident sellers. Also in 1990, in conjunction with these statutory changes, FTB exercised its existing general withholding authority to require domestic (U.S.) nonresident partner withholding beginning in 1991. (See FTB Notice 90-5, August 20, 1990.)

In 2002, AB 2065 (Stats. 2002, Ch. 488) extended real estate withholding to sales by California resident individuals. In 2006, AB 2962 (Stats. 2006, Ch. 428) established the alternative withholding amount, allowing sellers to elect to have tax withheld based on the gain taxed at the highest marginal rate applicable to the seller.

Also in 2006, FTB notified S Corporations of its intent to begin requiring S Corporations to withhold on distributive shares of California source income to nonresident shareholders, and amended Pub. 1017 accordingly.

2. Modernization, Conformity and Compliance Goals

a. Modernization – The goal is to position California to pursue automation of manual processes, which could result in cost savings and increased taxpayer service. Remittances being posted to proper taxpayer accounts when received could allow taxpayers to verify amounts credited to their accounts more easily when computing required estimated tax installments. Any proposed change should be considered in light of this goal.

b. Conformity – California law conforms to federal law as a general policy, and there are significant compliance and administrative advantages to being able to use federal figures and data. The regulations should be flexible enough to anticipate conformity to federal law and practice and allow use of federal information to verify compliance.

c. Compliance -- The purpose of withholding is to ensure that California source income is withheld upon in situations where the taxpayer may not file a California tax return or include California source income on a California return, and where it would be difficult or costly for FTB to discover, audit and collect the California tax due from the transaction or payment subject to withholding. Any proposed change should be evaluated with respect to this goal.

3. Specific changes proposed for 2008

- a. Due dates for nonresident withholding reporting and remittance will be simplified to match estimated tax due dates.
- b. Credits for specific taxpayers will be identified with remittances at the time of payment so that the proper accounts can be updated.
- c. Draft forms and publications include these revisions along with other updated procedures.

4. Regulations and forms - Feedback and Discussion

- a. Review language of draft Regulations 18662-0 through -8, 19002, collect comments.
- b. Review draft forms highlighting changes, collecting comments.

5. Future report and incorporation of suggestions to regulations.

After the meeting, FTB staff will draft a comprehensive feedback report that will contain responses to all comments collected prior to and during the meeting.