

# **REPORT ON INTERESTED PARTIES MEETING TO CHANGES TO THE WITHHOLDING AT SOURCE REGULATIONS, PUBLICATIONS, FORMS AND INSTRUCTIONS**

## **(Discussion Draft of Amendments to California Code of Regulations, Title 18, Sections 18622-0 through 18662-8 and 19002)**

The interested parties meeting was held at 10:00 a.m. on August 13, 2007, at the Franchise Tax Board's Central Office in Rancho Cordova, California. The facilitator was Bruce Langston, Tax Counsel for the Franchise Tax Board.

Prior to the interested parties meeting, a topic list, discussion draft regulations and draft forms and instructions for 2008 were made available on the Franchise Tax Board's website. In addition, staff encouraged the submission of questions and comments before, during and after the meeting in writing, electronically and by telephone.

The meeting began with an overview of the history of withholding at source in California and the reasons that FTB staff is proposing changes. Staff then presented the goals of modernization, conformity and compliance, and discussed how the proposed changes advanced each of these goals, and briefly outlined the major procedural changes that are being reflected in the draft forms for 2008 and included in the updated regulations. The major changes are that due dates for reporting and remitting withholding will be changed from monthly due dates to quarterly due dates, matching the estimated tax due dates, and that the taxpayers for whom withholding is to be credited must be identified as the payments are remitted, so that the withholding can be posted as a credit to the taxpayers' accounts.

Staff then went through the discussion draft regulations and the proposed forms, noting the changes and asking for questions. The outline below organizes the comments by regulation section and indicates the staff consideration and action on each suggestion. Staff also reviewed the draft language and made additional technical changes.

### **§ 18662-0 Table of contents**

Comments: No specific comments were received on this section.

Proposed Action: No change to the draft language.

### **§ 18662-1 Withholding at source – Generally**

Summary: This section explains the scope of the regulations. Specifically, it provides that the regulations under section 18662 cover only the withholding at source program administered by the Franchise Tax Board and does not apply to wage withholding (administered by the Employment Development Department); withholding orders for delinquent taxes; withholding on foreign (non-U.S.) partners (California law conforms to federal law in this area and federal regulations and procedures apply.)

Subsection (b) explains that under the statute, withholding at source is required from all payments of California source income, unless specific exceptions apply. Withholding may nevertheless be required even if an exception applies if the Franchise Tax Board has specifically notified the payor to withhold. Real estate withholding is required under the statute from the proceeds of a sale or disposition of California real property by both residents and nonresidents, and from business entities that have not established that they are in good standing as California business entities.

Comments:

1. Effective Date: Multiple comments were received asking about the proposed effective date of the changes to the regulations. Under Revenue and Taxation Code section 19503(b) as a general rule, no regulation shall apply to a taxable year ending before the date on which any notice substantially describing the expected contents of the regulation is issued to the public. These amendments were first noticed during 2007, and so unless one of the specific exceptions in section 19503 applies, they will not apply to years before 2007. Certain changes discussed at the Interested Parties Meeting are changes to FTB procedures reflected in forms and publications that will apply to amounts withheld and remitted during the 2008 calendar year and later. The effective date of the draft regulation does not apply to provisions of the existing regulations or to revisions that may be accomplished without a regulation.
2. Agency Intercept Program. One comment asked if the draft regulations are related to the interagency intercept program (Government Code section 12419.5). The regulations do not apply to the interagency intercept program.
3. Interest and Dividends Not Subject to Withholding. A number of comments simply requested that we clarify that interest and dividends received by nonresidents or non-California business entities are not subject to withholding at source.
4. Withholding Payment Information Available on FTB Online Website. One comment asked if withholding information (specifically, amounts withheld from real estate transactions) will be available during the tax year on FTB's online "View Payments and Balances Due" web page <http://www.ftb.ca.gov/online/myacct/index.asp>. Staff responded that this is not possible until the changes to the 2008 forms and procedures are in place to capture the information about the payments for each payee. After that happens, FTB will explore including these payments so that taxpayers can view the credits available for the tax year as they are posted.

Proposed Action:

1. Amend 18662-1 to clarify that the regulations apply generally to codify existing administrative practice for the 2008 and later calendar years, and will become effective upon enactment. Explain that additional changes in the form, time and manner of

payment, returns and statements may be required in the future, and annual forms and instructions will be revised accordingly

2. Amend 18662-1 to add "agency intercept program" as a specific item that is not within the scope of the regulations.
3. Add a cross reference to Chapter 11 of Part 10 (sections 17951 – 17955) to clarify that the same sourcing rules that apply to gross income of nonresidents apply to withholding from that income.
4. No change to draft regulations.

### **§ 18662-2 Definitions**

Summary: This section provides definitions for various terms used in the regulations.

Comments: Definition of "California Real Property"

Proposed Action: Add definition of California real property from FTB Publication 1016 as including various ownership interests in real property located in California including fee simple interests, life estates, reversions, remainders, and easements.

### **§ 18662-3 Real Estate Withholding**

Summary: This is a new regulation section implementing the real estate withholding requirements enacted in 2002 and modified in 2006. Generally, the draft regulation follows and summarizes existing statutory requirements and administrative practice as reflected in FTB Publication 1016, Real Estate Withholding Guidelines.

Comments:

1. California Law Differences. One comment noted that under RTC section 17152(a), 18 months of Peace Corps service can be used to satisfy the 2-year principal residence requirement under IRC section 121(a). Staff notes that there are also other possible exceptions to the federal rules that might apply for California, set forth in RTC section 17152. In addition, due to federal conformity mechanics, there could be differences each year if the federal law is changed and California law does not conform. These differences are more properly reflected in annual forms than in regulations.

Proposed Action:

1. Add a sentence to 18662-3(d)(4) explaining that due to differences in state and federal law, some transactions may qualify for exclusion under state but not federal law, or vice versa, and that such differences will be included in the annual changes to forms and instructions.

## § 18662-4 Withholding on Payments (Nonresident Withholding) – General

Summary: This section revises and updates the current regulations to provide general rules applicable to withholding on payments (Nonresident withholding). This section is intended to cover rules that apply to the three main non-real estate program areas set forth in detail in sections 18662-5 through 18662-7. The main changes in this section are the clarification of the de minimis amount of \$1,500, providing that withholding is optional on amounts where withholding is not required and specifying that withholding is required for payments to business entities that are not in good standing. Business entities not in good standing include suspended and forfeited corporations. It also sets forth "safe harbor" rules that allow the withholding agent to assume that an individual is a California resident or that a business entity has a permanent place of business in California if payment is made to a California address.

Comments:

1. Return Filing Requirement. One commentator objected to the requirement to file a California return set forth in subsection (g). The filing requirements are outside the scope of this regulation. However, it should be noted that the late filing or failure to pay penalties are computed after taking withholding into account (see RTC sections 19131(c) and 19132(c)). So, where sufficient withholding is remitted equaling or exceeding the tax due for the year, there will be no late filing or late payment penalties even where a return is not filed.
2. Payments of California Source income to a California Trust. A trustee of a trust with California situs oil royalty income currently requests and is granted waivers from withholding for payments made to nonresident beneficiaries, based on a history of compliance by the nonresident beneficiaries filing California returns and reporting the California royalty income. There is no allegation of "hardship" in the waiver request. The question was whether the waiver will still be allowed under the revised regulations and forms. The answer is that FTB will continue to allow administrative waivers for a history of compliance. If a payee has a history of filing and payment, and is current on outstanding tax obligations, FTB will normally grant a waiver, whether or not there is a "hardship."
3. Regulated Investment Company (RIC) Income. Revenue and Taxation Code section 17955 generally provides that for purposes of computing taxable income of a nonresident or part-year resident, gross income from sources in California shall not include dividends, interest or gains or losses from certain qualifying investment securities, including RIC dividend distributions. A suggestion was made to state specifically in the regulation that income excluded under Revenue and Taxation Code section is not required.
4. Interest and Dividends Not Subject to Withholding. A number of comments simply requested that we clarify that interest and dividends received by nonresidents or non-California business entities are not subject to withholding at source.

5. Payments to suspended corporations. Multiple comments were received asking whether the withholding agent must check the Secretary of State website to ensure that a payee is in good standing, because of the language in the draft regulations that requires withholding from payments to suspended or forfeited corporations. Staff notes that under current procedures, withholding agents may rely on statements made on the withholding exemption form, unless they know or have reason to know that the statement is false. The draft regulation does not intend to change this practice. Another comment questioned why withholding would be required from payments "by" suspended corporations, where the payee is otherwise exempt from withholding since the purpose of withholding is to ensure that California source income received by the payee is properly reported and has nothing to do with the status of the payor. Staff agrees with this comment and will limit the requirement to amounts paid "to" a suspended corporation and not include payments "by" a suspended or forfeited corporation.

6. Payments to IRC section 527 organizations. A comment asked if payments to IRC section 527 organizations would also be exempt as well as payments to IRC section 501 organizations. Staff notes that the draft regulations states that payments to all organizations federally exempt under Subchapter F of the IRC are exempt, which includes both sections 501 and 527.

7. Reduced Withholding Amount Request. One comment was received requesting clarification about the proposed procedures for requesting a reduced withholding amount based upon the Net California Source Payment. Staff notes that the prior procedure was to request a reduced percentage on the gross amount, while the revised procedure computes net amount, then applies the standard 7% rate.

8. Optional Withholding on First \$1500. It is unclear at whose option withholding on the first \$1500 of payments during the year may be made. Staff notes that current forms and instructions direct the withholding agent to withhold on all amounts if it is expected that the total distributions during the calendar year will exceed \$1500, and that when a distribution exceeding \$1500 is made, the entire amount is subject to withholding, not just the amount exceeding \$1500. The draft regulations simplify this rule by stating that withholding is optional on the first \$1500. Since it is the withholding agent's obligation to withhold, the determination of whether to withhold on optional amounts under \$1500 must be made by the withholding agent.

#### Proposed Action

1. No change to regulation.
2. Delete the word "hardship" in 18662-4(f) and revise the language to track the reasons for waiver allowed under current FTB procedures.

3. Add a new subsection to 18664-4(b) stating that withholding is not required on income excluded from "taxable income of a nonresident or part-year resident" under Revenue and Taxation Code section 17955.
4. Add a specific reference to Revenue and Taxation Code section 17952 and Regulation section 17952 to clarify that income from intangibles is generally not California Source income if received by a nonresident.
5. Delete the "or by" a suspended corporation language from Section 18662-4(h). Retain the language stating that withholding is required from any payment to a suspended corporation, if the payee has knowledge of, or has reason to know of the suspension or forfeiture.
6. No changes proposed to draft regulations. Section 18662-4 (b)(3) states an exempt organization is exempt from withholding if it meets the requirements of Subchapter F of the IRC (commencing with Section 501). Section 527 organizations are within the scope of Subchapter F and therefore would be exempt from withholding.
7. No changes proposed to draft regulations. Section 18662-4 (f)(3) states that a payee can request a reduced withholding amount to reflect expenses, costs, or other special circumstances that would justify a reduction. FTB is creating a new form and instructions (Form 589, Nonresident Reduced Withholding Request) for this purpose. Additional information will be included in the 2008 revised Publication 1017, Nonresident Withholding Guidelines.
8. Amend the draft regulations in 18662-4 (a) (2) to specify that withholding is optional, at the discretion of the withholding agent, on the first \$1,500 in payments made during the year.

#### **§ 18662-5 Non-Wage, Independent Contractor, Rents and Royalties**

Summary: This section generally summarizes and codifies existing administrative practice as reflected in the current regulations and explained in FTB Publication 1023, Nonresident Withholding Independent Contractor Rent and Royalty Guidelines.

Comments: No comments were received that specifically address the provisions of this section.

Proposed Action: No change to draft language.

#### **§ 18662-6 Entertainers, Athletes and Speakers**

Summary: This section generally summarizes and codifies existing administrative practice as reflected in the current regulations and explained in FTB Publication 1024, Nonresident Withholding – Entertainment Guidelines.

Comments: No comments were received that specifically address the provisions of this section.

Proposed Action: No change to draft language.

### **§ 18662-7 Domestic (U.S.) Pass-through entities**

Summary: This section generally summarizes and codifies existing administrative practice as reflected in the current regulations and explained in FTB Publication 1017, Nonresident Withholding S Corporation and Partnership Guidelines.

Comments:

1. Multiple pass-through entity untimely returns. One commentator pointed out that the current rules are impossible to comply with if a pass-through entity in which the taxpayer is a partner or member does not file returns by April 15, but files under extension. Therefore it can never file its form 592 (Nonresident Withholding Annual Return) on time since it does not know how much income or withholding credit is available for it in turn to pass through to its own owners.

Staff notes that this situation is precisely why two major procedural changes were put in place for the 2008 calendar year and reflected in the regulations:

First, in draft regulation section 18662-7(f), we have revised the due dates for remitting withholding on prior-year distributions. Under the new draft procedures, where a distribution is made after the tax year closes, the report and remittance is not due (and so is not delinquent) until the first quarterly due date after the withholding is actually done. (See draft section 18662-7(f)(3) example 2.)

Second, the general procedure for reporting remittances of withholding has been changed to require the identification of the payee along with the remittance of the withholding and notice to the payee at the time of the withholding is remitted. So, in the situation where distributions subject to withholding are actually made during the tax year, the payee should have notice of each withholding amount and can claim the withholding as a credit on the tax return filed for the year, even where the actual K-1 is not provided until later.

2. Regulated Investment Company (RIC) Income. Revenue and Taxation Code section 17955 generally provides that for purposes of computing taxable income of a nonresident or part-year resident, gross income from sources in California shall not include dividends, interest or gains or losses from certain qualifying investment securities, including RIC dividend distributions. A suggestion was made to state specifically in the regulation that payments of income that are excluded under Revenue and Taxation Code section 17955 are not "payments subject to withholding."

3. Real Estate Investment Trust (REIT) Income. One comment was received requesting clarification on whether Real Estate Investment Trusts should withhold on distributions.

4. Due Date for Partnerships. One comment was received requesting clarification on when partnerships should withhold on distributions to partners.

Proposed Action:

1. No action necessary as the concerns are addressed in existing draft language.

2. Add a sentence to 18664-7(b) stating that payments subject to withholding do not include income excluded from "taxable income of a nonresident or part-year resident" under Revenue and Taxation Code section 17955.

3. No changes to proposed draft regulations. Question 68 in Publication 1016, Real Estate Withholding Guidelines, provides that REIT's are treated as corporations for withholding purposes. Since REIT's are treated as corporations, we do not currently require withholding from distributions (dividends) paid by REIT's, because the distributions are treated as intangibles under the Personal Income tax Law, and so not considered California source income of nonresidents.

4. No changes to proposed draft regulations. Section 18662-7 (a)(1) specifies when S corporations and pass-through entities must withhold. In addition, see Questions 17 and 69 in current Publication 1017, Nonresident Withholding Partnership Guidelines address when partnerships are required to withhold.

### **§ 18662-8 Reporting and Remitting Withholding**

Summary: This section consolidates all the rules relating to reporting and remitting payment of withholding at source.

Comments:

1. Quarterly Reporting and Payment. Multiple comments were received expressing concerns about the ability to comply with the requirements to identify payees at the time the withholding is remitted, and to remit the withholding within 15 days after the close of the quarter. Staff notes that some of these comments acknowledge the problem faced by FTB in being able to advise taxpayers of the credits to their accounts during the year under the current system, but appear to be urging that implementation of the changes be delayed to allow various systems to be changed to accommodate the new rules. As explained in the comments under the "Effective Date" heading in 18622-1, the change to quarterly reporting and identification of specific taxpayers are being made under the FTB's existing authority to prescribe the form and manner of reporting and payment, so this is not properly an objection to the regulation. However, FTB plans to be cautious in assessing penalties for failure to comply with the new procedures, and notes that there

is a reasonable cause exception available to withholding agents who are unable to comply with the new procedures.

2. Errors or Amendments to Withholding amounts or payments. One commentator requested clarification on erroneous withholding done by the withholding agent and how to amend the appropriate forms, get a possible refund of the erroneous withholding, or allocate the withholding to another nonresident. Another comment asked what mechanism a company will have to get a refund of erroneously reported and paid withholding on payments made to a corporation. The commentator provided an example of two corporations with similar names, one corporation in good standing qualified to do business in California with a valid exemption certificate on file, and one not qualified in CA, subject to withholding. Where the withholding agent mistakenly withholds from the California corporation, erroneously believing that the payment was made to the non-California corporation, the withholding agent would like to be able to reimburse the California corporation immediately for the mistaken withholding and claim a refund from FTB.

Another comment in support of an ability to refund or amend if withholding is done erroneously explains: "Production staff are often paid by a payroll company who is the employer of record. The entertainment industry wants a formal procedure for filing amended withholding statements where they later discover that the withholding was excessive (somewhat like the current procedure for filing amended W-2's). They would like to have the option of having the money refunded or credited back to the withholding agent so that they can use it to satisfy the next quarter's withholding obligation for the same or different clients."

#### Proposed Action

1. No changes proposed to draft regulations. Section 18662-8 (c) outlines the payment due dates, which are consistent with estimated tax payment due dates. The requirement that payees be identified when the withholding is remitted to FTB will allow us to apply the withholding credit to the appropriate taxpayer in a timely fashion. If a withholding agent is unable to identify the payees when the withholding is remitted, the withholding agent will be instructed to provide FTB the information as soon as feasible, but no later than the end of the calendar year. Forms and publications will be updated to reflect these new regulations and procedures.

2. Amend the draft regulations 18662-8(c) to add a provision allowing withholding agents to submit amended forms to FTB. Procedurally, FTB will allow the withholding agent to amend the forms and request a refund at the discretion of the withholding agent. Otherwise, the withholding agent may amend the forms and FTB will retain the withholding amount in the name of the withholding agent, which can then claim the excess withholding on a later quarterly Form 592 as a prior payment. However, the withholding agent must balance their account by the end of the taxable year. Forms and publications will be modified to add clarification.

## § 19002 Credit for Tax Withheld

Summary: This section renumbers and amends existing regulation 25401b, adding specific guidance for the credit of withholding of payments to pass-through entities, and the date of the credit for withholding.

Comments:

1. Withholding Credit Follows Associated Income. It is not clearly stated that individuals may only claim a credit for withholding to the extent that the item withheld upon is shown as income on a tax return. Staff notes that in some circumstances taxpayers will claim a credit for withholding but not show the associated income on a tax return. For example, where community property income is split between spouses filing separate returns, the associated withholding must also be allocated in the same manner as the income.

Proposed Action

1. Amend draft section 19002(a) to provide that the credit is allowable only to the extent that the payment withheld upon is shown as income on a return for the year.