

Regulation section 18662-5 is amended to read:

§ 18662-5. Remedies of Taxpayer Non-Wage, Independent Contractor, Rents and Royalties, Beneficiaries of Estates and Trusts.

If, as a result of the action of a withholding agent in transmitting the tax to the Franchise Tax Board, taxpayer's tax is overpaid, the taxpayer is entitled to file a claim for the refund or that overpayment, and to appeal to the Board of Equalization or to an action in the courts, to the same extent as if the taxpayer himself had made the overpayment. Refund claims must be filed within four years after the last day prescribed for the filing of the taxpayer's return, or within one year after the payment of the tax by the withholding agent, whichever period expires the later. Interest is to be allowed in all such cases, to be computed at 6 percent per year from the 15<sup>th</sup> day of the fourth month following the close of the taxable year for which such amounts were withheld. The taxpayer cannot hold the withholding agent liable for any payment made to the Franchise Tax Board pursuant to Reg. 18662-1 to 18662-5, unless the amount withheld is refunded to the withholding agent.

(a) Payments Subject to Withholding.

(1) Generally. As explained in Regulation section 18662-4, withholding agents are required to withhold from all payments or distributions of California source income made to a nonresident when the payments or distributions are greater than \$1,500 for the calendar year, unless the withholding agent receives authorization for a waiver or a reduced withholding amount from the Franchise Tax Board. As a general rule, payments of income that must be reported on a federal form 1099-MISC are payments of the type that may be subject to California withholding at source if the recipient is a nonresident individual or a non-California business entity.

(2) Specifically Subject to Withholding. The following California source income is specifically subject to withholding:

(A) Payments made for personal services performed in California. The source of income from personal services is the location where the services are performed, and not where the nonresident lives, the location where the contract for services is entered into, or the place of payment.

(B) Payments received for a covenant not to compete in California.

(C) Payments releasing a contractual obligation to perform services in California.

(D) Income from options received as a result of performing personal services in California.

(E) Bonuses paid for services performed in California.

(F) Rents and royalties from assets in California.

(G) Taxable prizes and awards paid in California or paid for competitions or contests in California, including game shows, races, auto, horse and dog racing.

(H) Distributions of California source taxable income to nonresident beneficiaries from an estate or trust, including both cash and non-cash distributions.

(I) Any other amount of California source income for which a state or federal information return is required to be filed.

(3) Business Situs. Income from intangible personal property such as stocks, bonds, notes, etc., is not income from California sources unless the property has acquired a business situs in California. A California business situs is acquired when the property is employed as capital in California. A California business situs is also acquired when the possession and control of the property has been localized in connection with a business, trade, or profession in California so that its substantial use and value attach to and become an asset of that business. The entire income, including the gain from the sale of such an asset, is income from California sources. Examples include an intangible asset pledged as security for a loan connected to a California business or a bank account maintained to pay expenses related to business activities in California. (See Regulation section 17952.)

(4) Tax Treaties – Payments to Foreign Individuals or Entities. California does not conform to federal law relating to income protected by U.S. tax treaties. California source income is taxable and subject to withholding. Nonresident aliens are required to report income from California sources on Form 540NR, California Nonresident or Part-Year Resident Income Tax Return. The payee may request a waiver or reduced withholding rate if the statutory amount will result in over-withholding. See Regulation section 18662-4 for additional information regarding waivers and reduced withholding rates.

(5) Payments Made to Reimburse Expenses. If the reimbursement is separately accounted for and is not subject to federal information return (Form 1099) reporting, withholding is not required on payments to reimburse nonresidents for expenses relating to services performed in California (corporate payees, for purposes of this exception, should be treated as individual persons). When the reimbursed expenses do not meet these requirements, withholding agents should withhold on the total payment.

(6) Services in Connection With the Sale of Goods. Withholding is required on the portion of the sale that relates to services provided in California. A Nonresident Income Allocation Worksheet may be used to distinguish the portion of payments made for goods from the portion for services.

(b) Payments to Independent Contractors. See California Unemployment Insurance Code sections 13000, et. seq., for the definition of "employee" subject to wage withholding. Individuals other than employees who perform personal services in California are independent contractors subject to withholding for purposes of this regulation.

(c) Payments to Subcontractors. The withholding agent is required to withhold when making payments directly to nonresident subcontractors for services performed in California. When the withholding agent makes payments to more than one contractor, the withholding agent should provide each contractor with a Nonresident Income Allocation Worksheet and/or a Withholding Exemption Certificate to determine if withholding is required. If the withholding agent knows of only one contractor, then the withholding agent should use the information provided by the contractor-of-record. If the contractor is a resident and provides an exemption certificate, no withholding is required. However, if the contractor-of-record is a nonresident, withholding is required on the total payment. Withholding is not required on payments to general contractors who are California residents. However, general contractors must withhold on payments made to nonresident subcontractors for services performed in California.

(d) Rent or Royalty Payments.

(1) Rent or Lease Payments Made to Nonresidents. Withholding on rent or lease payments to nonresidents is required when all of the following criteria are met:

(A) The payments are made in the course of the lessee's business. (Tenants of residential property are not required to withhold on payments made to nonresident owners.)

(B) The rented or leased property is tangible property located in California.

(C) The total payments of California source income to the lessor by the lessee exceed \$1,500 for the calendar year.

(2) Types of Rental or Leased Property Subject to Withholding. Withholding is only required when the payers of rent are renting or leasing property in the course of their business from a non-California owner. Although withholding is not required from tenants of residential real property, income derived from real property, such as land and buildings, as well as income derived from tangible personal property located in California, such as machinery equipment, vehicles, aircraft, etc., is California source income and is subject to California tax. This includes rents, lease payments and the gain on the sale of such property.

(3) Royalty Payments Made to Nonresidents. California requires withholding agents to withhold on royalties paid for the right to use natural resources located in California, including, but not limited to, oil, gas, other minerals, geothermal, and timber. Withholding is also required on royalty or residual payments made to nonresidents for services originally performed in California and for payments of royalties derived from a business or activity with a business situs in California. See Regulation section 17951-2.

(e) Payments to Corporate Directors. (1) Withholding Not Required. Revenue and Taxation Code section 18662, subdivision (g), exempts wages, salaries, fees or other compensation paid by a corporation for services performed in California for that corporation to a nonresident corporate director for director services, including attendance at a board of directors' meeting, from withholding at source. Nonresident directors must file California tax returns reporting this California source income, unless they elect to be included in a group return under Revenue and Taxation Code section 18536

(2) Filing of Information Return. An entity paying wages, salaries, fees or other compensation to a nonresident director must file an information return with the Franchise Tax Board as required by Revenue and Taxation Code section 18631 and applicable regulations, and provide the payee with a payee statement. To meet the payee statement requirement the paying entity must file a federal information return (Form 1099-MISC) with the Internal Revenue Service and provide a copy of that form to the payee.

(f) Seminars and Expert Witnesses. Withholding is required on payments that are compensation for services performed in California by a nonresident, including seminar speakers and expert witnesses.

(g) Income Allocation.

(1) Nonresident Contractors. When nonresident contractors perform services within California as well as outside of California, reasonable methods may be used by the withholding agent to determine what portion of the services are provided within California. In addition to the two approved methods below, withholding agents may use other reasonable methods approved by the Franchise Tax Board.

Method 1: The withholding agent may request that the payee complete a Nonresident Income Allocation Worksheet to determine the amount of California source income subject to withholding. The withholding agent uses the information provided to determine if withholding is required, and, if required, what portion of the payment is subject to withholding.

Example: A withholding agent sends a Nonresident Income Allocation Worksheet to an out-of-state independent contractor (vendor) before making a payment for services. The total contract amount is \$100,000. The nonresident vendor returns a

Nonresident Income Allocation Worksheet, certifying that \$60,000 is for services performed in California and \$40,000 is for work performed in another state. The amount of withholding would be:

\$60,000 California source income X 7% Withholding rate = \$ 4,200. (Note: If the amount subject to withholding (\$60,000 in the example above) is equal to or less than \$1,500, no withholding is required.)

Method 2: The withholding agent may rely on the nature of the work performed to indicate where the services are performed.

Example: A construction company building a shopping center is most likely performing services where the shopping center is located. A good faith effort by the withholding agent to comply with the withholding rules will satisfy this requirement.

(2) Reliance on Allocations Provided by Payees. Withholding agents may generally rely on allocations provided by payees on a properly completed and signed Nonresident Income Allocation Worksheet to establish reasonable cause for the abatement of penalties. Withholding agents suspecting that a Nonresident Income Allocation Worksheet has been fraudulently completed should provide a copy of the form to the Franchise Tax Board and include an explanation as to why they believe the form is fraudulent. The withholding agent may generally rely on the information provided by the vendor until the Franchise Tax Board issues notification to revise the allocation or withdraw the exemption. See Regulation section 18622-8 for retention and filing requirements for Nonresident Income Allocation Worksheets.

(3) Appropriate Denominator for the Ratio When Using an Allocation Based on Time. Compensation for personal services performed by nonresident independent contractors will normally be allocated to California based on working days in California to total working days in and out of California ("duty days" for professional athletes – see Regulation section 18662-6). The number of days covered by the vendor's contract can only be used when the vendor is:

- (A) Hired for the exclusive use of the payor for the entire contract period,
- (B) Required to be available to work each day at the discretion of the payor during the contract period, and
- (C) Being paid whether or not providing services.

Days spent acquiring knowledge, skills, or necessary experience as a condition of employment are not considered work days. Professionals and others who bill by the hour should allocate compensation based on the number of billable hours worked in California to the total number of billable hours related to the particular service.

(4) Determining the Portion of the Payment Related to Services When Payments are Made for Goods and Services. Withholding agents must use a reasonable method. One reasonable method is to use the same allocation of goods and services that is used for sales and use tax purposes in the sales contract. The portion of the payment **not** subject to sales or use tax would be considered payment for services and subject to withholding. If a payment is not subject to California sales or use tax, but is subject to another state's sales or use tax, withholding agents may also use the allocation for the other state to determine the portion relating to services and subject to withholding.

Generally, under sales and use tax laws, charges for labor or services for installation are not subject to sales or use tax. Payments for installation would be subject to withholding. Charges for designing, consulting, performing feasibility studies, evaluating bids and providing training services are also considered service activities if they are separately stated and not part of the sale of tangible personal property. Payments for repairs would be subject to withholding, except for parts that are separately stated on the invoice. As payments for mandatory maintenance contracts or warranties are subject to sales tax, even if the cost of the maintenance contract or warranty is separately stated, the payments would not be subject to withholding. However, payments for optional maintenance contracts or warranties are not subject to sales tax so would be subject to withholding. One exception is transportation charges, so that even if the payment for transportation charges is not subject to sales or use tax, withholding is not required.

(5) Allocation of Distributions. Allocation of distributions between California and non-California source income based on past year's allocations for withholding purposes may be made by the trustee of a trust. If the trustee does not know the amount of California source income included in a distribution, the trustee may use the previous year's ratio of California source income to total income to allocate the distribution.

Note: Authority cited: Section 19503, Revenue and Taxation Code.  
Reference cited: Section 18662, Revenue and Taxation Code.