

Regulation section 18662-7 is amended to read:

§ 18662-7. Certificates of Residence Nonresident Withholding -- Domestic (U.S.) Pass-Through Entities.

(a) If a payee claims exemption from withholding pursuant to this regulation on the grounds that the payee is a California resident, the payee shall execute a Certificate of Residence in a form prescribed by the Franchise Tax Board. The original and one copy of the executed certificate will be filed by the payee with the payor. The payor must transmit the original certificate to the Franchise Tax Board before making any payments to the payee. If the payee's resident status continues, the retained certificate shall relieve the payor from withholding on such payee for the remainder of the calendar year or until otherwise directed by the Franchise Tax Board's Notice to Withhold, whichever date is sooner.

(b) If a payee's status during the year changes from nonresident to resident, a Certificate of Residence should be filed with the payor, in accord with subsection (a). If the change is from resident to nonresident status, a Certificate of Nonresidence and Claim for Personal Exemption Credit on a form prescribed by the Franchise Tax Board may be filed by the payee with the payor.

(a) General Information and Withholding Requirements.

(1) General. S corporations and other pass-through entities (general and limited partnerships, including limited liability companies classified as partnerships) must withhold on distributions of current or prior year income to domestic nonresident S corporation shareholders and nonresident partners (including members of Limited Liability Companies treated as partnerships for tax purposes). Withholding is optional on the first \$1,500 in distributions during the calendar year. Withholding is a prepayment of California state income or franchise tax for nonresident shareholders or partners. The income recipient must file a California tax return to claim a credit for withholding. The withholding rate is 7% of California source income distributed.

(2) Non-US Partners. Non-US partners (including non-US members of limited liability companies classified as a partnership) are not subject to this regulation. California conforms to federal law with respect to withholding on foreign (non-U.S.) partners. See Revenue and Taxation Code section 18666, Internal Revenue Code section 1446, and Treasury Regulations section 1.1446-0, et. seq.

(b) Payments Subject to Withholding. Distributions are subject to withholding to the extent they represent California source income. For purposes of this section, "California source income" does not include return of capital, income sourced in another state, or other income not subject to tax by California. It also does not include income earned by partners in "investment partnerships" excluded from taxable income of a nonresident or part-year resident under Revenue and Taxation Code sections 17955 or 23040.1.

(c) Individuals and Entities Subject to Withholding and Residency Status. Generally, withholding is required on payments to individuals who are nonresidents of California and business entities that are not incorporated in California, qualified to do business in California, or have a permanent place of business in California. Withholding is required unless an individual recipient has established California residency or a business entity has established a permanent place of business in California, incorporated in California or formally qualified to do business in California. See Regulation section 18662-4.

(d) Waivers and Reduced Amounts. The Franchise Tax Board will consider waiver requests or requests for reduced withholding amounts on a case-by-case basis, in unusual circumstances where the individual or entity recipients demonstrate a compliant filing history, and where withholding from the payment would cause hardship or where there will be no tax liability resulting from the payment. See Regulation section 18662-4.

(e) Partnerships and Other Pass-Through Entities That Have Been Withheld Upon.

(1) General. As a general rule, pass-through entities that have been withheld upon may use some or all of the withholding to satisfy entity-level tax, but must pass-through any remaining withholding as a credit to shareholders, partners or members according to their respective ownership interest in the entity. See Regulation section 19002. Single-member Limited Liability Companies and other disregarded entities should follow the rules applicable to the owner.

(2) Partnerships. As partnerships have no tax liability except for the annual tax paid by limited partnerships and limited liability partnerships, which annual tax is due on the original due date of the return for the year, any withholding can only be claimed against the entity's own liability up to the amount of the annual tax that is still due and unpaid at the time the return is filed. Partnerships may not receive a refund of withholding. The withholding in excess of the tax due must be allocated to the partners. (Even if the partnership will owe tax, the partnership can still choose to allocate the entire withholding to its partners instead of using a portion to offset the tax due.)

(3) Limited Liability Companies Classified as Partnerships. Limited liability companies classified as partnerships can either allocate the entire withholding credit to its members or elect to use a portion of the credit to offset any limited liability company tax (including nonconsenting nonresident tax) or fees still due, and allocate any excess to its members. Limited liability companies may not receive a refund of withholding.

(4) Estates and Trusts. Withholding on estates and trusts must follow the income. If the related income is not being distributed in the current year to the beneficiaries, the related income must be shown and the withholding credit must be claimed on the tax return filed for the taxable year. If the related income is being

distributed in the current year, the withholding credit must be allocated to the beneficiaries.

(5) S Corporations. As S corporations are subject to California income or franchise tax at the entity level, S corporations can elect to allocate all or a portion of the withholding credit to the S corporation shareholders, or to claim the withholding on the S corporation tax return. S corporations may not receive a refund of withholding. In order for an S corporation to claim any of the amount withheld as a credit against its own franchise or income tax, it must include a schedule in the body of its original return showing the amount claimed against the franchise or income tax and explaining how the remainder of the credit (if any) was allocated.

(6) Allocation. The withholding must be allocated to all partners, members, S corporation shareholders, or beneficiaries, whether they are residents or nonresidents of California, in proportion to their ownership or beneficial interest in the pass-through entity, unless a special allocation rule applies, in which case, the allocation of withholding follows the special allocation of the income.

(7) Timing. As explained in Regulation section 19002, withholding is treated as paid 25% on each estimated tax payment due date, unless the taxpayer elects to treat all withholding at source for the year as paid on the date withheld. Therefore, to avoid a penalty for underpayment of estimated tax, entities that are subject to the minimum franchise tax or the annual tax for LLCs classified as a partnership for the year must pay the full amount by the due date (generally, April 15th of the tax year for calendar year taxpayers), unless before that date they have received a statement from the withholding agent showing sufficient withholding during the year to cover the minimum franchise tax or the LLC annual tax, as applicable.

(f) Special Pass-Through Entity Rules.

(1) Interaction With Group Returns. Unless an exemption is applied for and granted, withholding is required on distributions of income to partners and members of group returns filed pursuant to Part 10.2 of the Revenue and Taxation Code. A credit is allowed against the tax shown on the group return for withholding amounts attributable to members of the group. Limited liability companies classified as a partnership that are required to include the income of certain members pursuant to Revenue and Taxation Code section 18633.5, subdivision (e), are also allowed a credit for withholding attributable to this income under Revenue and Taxation Code section 18633.5.

(2) Year-End Distributions, Prior Year Income, Late or Amended Withholding Amounts. As a general rule, the withholding from a payment or distribution applies to the same tax year that the income from that payment or distribution is reportable. If a distribution of prior year income is made after the end of the calendar (or taxable) year in which the income was earned, but before the due

date for the statement required to be provided to the payee, the withholding may be reported as if the withholding had been done in the just-completed calendar (or taxable) year. If the distribution of prior year income is after the due date for reporting withholding of the year following the calendar (or taxable) year in which the income was earned, the payment and statement should be remitted as a separate amount on or before the quarterly due date for distributions made in that month, clearly designated as a prior year distribution.

(3) Examples.

Example 1: A nonresident partner's share of the partnership's California source income for the partnership's taxable year 2007 is \$100,000. The partnership distributes \$50,000 in November 2007 and \$50,000 in January 2008. The partnership withholds on both distributions. The withholding from the \$50,000 distributed in November 2007 should be reported on a 2007 tax year withholding form (or electronically, designating the payment to apply to the 2007 tax year) by January 15, 2008. The \$50,000 paid in January may be reported on that same form at the same time, as if it had been paid on December 31, or alternatively, must be reported on a separate 2007 tax year form due April 15, 2008. If other distributions are made in the first quarter of 2008 of 2008 tax year income, those must be on a separate 2008 withholding form remitted April 15, 2008.

Example 2: The partnership does not make the second distribution in Example 1 until May 2008. Unless an exemption certificate is filed requesting an exemption from withholding for previously reported income, the second distribution is also subject to withholding. The November 2007 withholding is shown on 2007 forms, (or electronically, designating the payment to the 2007 tax year) due on or before January 15, 2008. The May 2008 distribution of 2007 income is shown on a tax year 2007 form but the form is not due until June 15, 2008. However, to allow the partner to file the 2008 tax return and claim the entire withholding credit, the reporting and remittance should be filed as soon as possible after the distribution.

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