

**FINAL STATEMENT OF REASONS  
PROPOSED AMENDMENTS TO REGULATION  
SECTIONS 18662-0 THROUGH 18662-6 AND 18662-8,  
PERTAINING TO WITHHOLDING**

**UPDATE OF INITIAL STATEMENT OF REASONS**

The public notice required by Government Code section 11346.4 was mailed and published in the California Notice Register on November 16, 2018. The notice stated that there would not be a public hearing unless requested by an interested person at least 15 days before the close of the written comment period, which ended January 8, 2019. No request was made for a public hearing, and no hearing was held.

Upon review of the proposed rulemaking file by staff, the Franchise Tax Board (FTB) issued a 15-Day Notice on April 24, 2019, to make additional substantive and sufficiently related changes. These changes were effectuated primarily to ensure consistency and conformity with Revenue and Taxation Code ("RTC") section 18662 and California Code of Regulations, Title 18 ("18 CCR" or "Regulations"), sections 18662-0 through 18662-6 and 18662-8, pertaining to real estate and nonresident withholding. FTB did not receive any comments as a result of this 15-Day Notice.

FTB also published a clarification to the Initial Statement of Reasons ("ISOR") with the 15-Day Notice, on April 24, 2019. During review of the proposed rulemaking file, FTB staff discovered clarifications were required within the ISOR's description of several proposed amendments to the regulatory text in order to avoid an unintentional misrepresentation regarding to whom withholding of tax at source is directed -- namely, that pass through entities (PTEs), as withholding agents, withhold tax at source on nonresident owners, not lower tier PTEs. Accordingly, within the clarification to the ISOR, the FTB modified the descriptions of each identified subsection of the Regulations as initially detailed in the ISOR.

Upon further review of the proposed rulemaking file by staff, the FTB issued a second 15-Day Notice, on July 3, 2019, to make additional substantive and sufficiently related changes. These changes were effectuated primarily to ensure consistency and conformity with RTC section 18662, and 18 CCR section 18662-3 (concerning withholding involving Internal Revenue Code, section 1031 exchanges). One comment was received as a result of the second 15-Day Notice. This comment is included in the rulemaking file, and a summary of the comment and FTB's response is detailed below.

The final text of the proposed Regulations, as published with the notice on November 16, 2018 and modified by the two 15-Day Notices, is included in the rulemaking file. The FTB has complied with the requirements of Section 44 of Title 1 of the California Code of Regulations.

**COMMENTS RECEIVED DURING THE PERIOD:**

**THE PROPOSED TEXT WAS AVAILABLE TO THE PUBLIC DURING THE NOTICE PERIOD FROM NOVEMBER 16, 2018 THROUGH JANUARY 8, 2019**

No comments were received during this period.

**THE FIRST 15-DAY NOTICE PERIOD FROM APRIL 24, 2019 THROUGH MAY 9, 2019**

No comments were received during this period.

**THE SECOND 15-DAY NOTICE PERIOD FROM JULY 3, 2019 THROUGH JULY 19, 2019**

One comment was received during the Second 15-Day Notice period and is summarized and addressed below.

**Summary of Comment 1: (see Rulemaking File Exhibit 8):**

The commenter contends that although RTC sections 18662-3(a) and 18662(c)(3) impose the duty to withhold from proceeds of the sale of California real estate upon the buyer, 18 CCR section 18662-3(d)(1)(C) shifts the burden of withholding to the Qualified Intermediary (QI) in a deferred exchange, leaving a withholding obligation gap. The commenter provides three scenarios where the withholding obligation gap arises: 1) when the seller receives some cash boot or non-like-kind property directly from the closing; 2) when the seller incurs debt relief; and 3) when there are insufficient funds held in the exchange account to cover the full withholding liability.

In the first scenario, the commenter states that the seller would receive an amount of sale proceeds directly from the buyer, and should direct that the escrow agent send only the remaining balance (net proceeds less the reserved amount) to the QI. The commenter contends that in this instance, both the seller and the buyer are aware that the seller is engaging in a partial exchange, and the reserved funds taken at closing are not “exchange funds,” are not and cannot later be tendered to the QI, and cannot be used to purchase qualifying replacement property in the like-kind exchange. The commenter believes that these reserved funds are boot received up front, and are fully taxable. The commenter further believes that since the buyer is on notice of the payment to the seller, the obligation to withhold from the portion of sale proceeds that is not included in the seller’s deferred exchange should remain on the buyer. Moreover, the commenter believes that the FTB should not shift a withholding burden to the QI on funds it will never receive, which are not subject to its contract with the seller, and which are not part of the deferred exchange. Moreover, the commenter states that the QI cannot use the exchange funds it holds to make the withholding payment prior to termination of the exchange without violating the tax rules restricting taxpayer benefit of the exchange funds. The commenter believes that if the QI refuses to fully fund a replacement property purchase, because it is holding back sufficient funds with which to pay withholding on the prior boot received by the seller, it would breach the terms of the exchange agreement and arbitrarily cause the taxpayer to incur additional boot in the amount of the withholding reserve that otherwise would have been used to acquire like-kind property.

In the second scenario, the commenter states that there is a withholding obligation gap when the taxpayer purchases replacement property (using all of the cash exchange funds) valued less than the sold relinquished property, but does not fully replace the

debt, and thus incurs debt relief boot. The commenter suggests that the phrase “withholding is required” in proposed Regulations section 18662-3(d)(3) is an improvement over the originally noticed Regulations text but is nevertheless troubled by the related commentary in the second 15-Day Notice, which states that “Removing this language in no way obviates or otherwise removes an intermediary’s or accommodator’s obligation to withhold.” In the opinion of the commenter, responsibility for withholding on excess debt relief should fairly and properly fall exclusively on the taxpayer—not on the QI, who is providing a ministerial service and should not be burdened with this task. The commenter contends that the QI lacks the detailed, private tax information known to the taxpayer and his or her accountant regarding how much debt actually needs to be replaced. The commenter suggests that although a hypothetical relinquished property in this scenario may have a gross sale price of \$100, the taxpayer may not need to fully spend \$100 on replacement property if there are expenses or concessions that reduce the effective (net) sale price. The commenter also believes that this scenario would potentially place the QI in the position of not having any funds with which to pay the withholding unless it arbitrarily refused to fully fund the purchase of the replacement property, putting the QI in breach of the exchange agreement.

In the third scenario, the commenter states that there is a withholding obligation gap when there are insufficient funds held in the exchange account to cover the full withholding liability. Specifically, the commenter contends that 18 CCR Section 18662-3(d)(3)(A)(2) requires withholding if the seller “receives any proceeds (including excess debt relief) or non-like-kind property from the sale (boot) in excess of \$1,500” at the rate of 3 1/3 percent, unless the seller has elected the alternative calculation. As a result, the commenter contends that the balance of exchange funds on deposit with the QI would be insufficient to cover the required withholding. The commenter suggests that this happens when exchange funds have properly been disbursed to escrow for purchase of replacement property or earnest money deposits, and then the exchange fully or partially fails because the closing of the replacement property purchase has been delayed beyond the exchange deadlines. According to the commenter, this scenario also occurs when the relinquished property was highly leveraged, and the net amount of exchange funds received by the QI is less than 3 1/3 percent. The commenter states that the FTB has taken the position that a QI will not be subject to a fine for failure to submit the full amount of required withholding if the QI makes a reasonable effort to demand payment from the taxpayer so that it can make the full withholding. The commenter recommends that the FTB amend the Regulations by adding additional text to proposed Regulations section 18662-3(d)(3)(A) to provide that a QI’s or accommodator’s required withholding shall not be in excess of the balance of funds on deposit after termination of an exchange, and language clarifying it is the seller/transferor’s responsibility for making up any amount required to be withheld that is greater than that balance.

## FTB Response:

Reject in full:

The proposed revisions to close the contended "withholding obligation gap" for the three (3) scenarios outlined above would conflict with the plain text of RTC Section 18662. Removing the phrase "withholding is required" from Regulation Section 18662-3(d)((3)(A)(1)-(3) and adding additional language to Section 18662-3(d)(3)(A), as proposed by the commenter, would conflict with RTC Section 18662 because an intermediary or accommodator must withhold when there is gain that the seller/transferor is required to recognize. All three (3) scenarios outlined by the commenter deal with the fact that a QI's withholding is based on the amount of gain from the sale of the property. However, RTC section 18662, at subdivisions (e)(2)(A) and (B), specifically tie an intermediary's or accommodator's required withholding to the amount of gain. First, RTC Section 18662(e)(2)(A) states the following: "Except as provided in subparagraph (B), in the case of any disposition of a California real property interest by a transferor described in paragraph (1), the transferee, *including for this purpose any intermediary or accommodator in a deferred exchanged, is required to withhold* an amount equal to 3 1/3 percent of the sales price of the California real property conveyed." (Emphasis added). Next, RTC Section 18662(e)(2)(B) provides: "If the transferor makes an election under this subparagraph, the transferee, *including any intermediary or accommodator in a deferred exchanged, is required to withhold* an amount equal to an amount certified by the transferor in writing under penalty of perjury. . . ." (Emphasis added). In addition, RTC Section 18662(e)(3)(D)(ii)(I) provides an exemption from withholding "if the transferee, in good faith and based on all the information of which he or she has knowledge, relies on a written certificate executed by the transferor, certifying, under penalty of perjury . . . [that the] California real property being conveyed is being exchanged, or will be exchanged, for property of like kind, within the meaning of Section 1031 of the Internal Revenue Code, *but only to the extent of the amount of the gain not required to be recognized for California income or franchise tax purposes under Section 1031 of the Internal Revenue Code.*" (Emphasis added).

Pursuant to the RTC, the QI is responsible for withholding on excess debt relief, as the phrase is used in 18 CCR sections 18662-3(d)(3)(A)(1) and (2), because the receipt of proceeds in the context of a 1031 like-kind exchange—including excess debt relief—would trigger a withholding requirement. Specifically, RTC Section 18662(e)(3)(D)(ii)(I) bases an intermediary's or accommodator's withholding on the amount of gain that the seller/transferor is required to recognize in a like-kind exchange. A seller/transferor is required to recognize gain under Internal Revenue Code (IRC) Section 1031(b), to which California conforms pursuant to RTC Sections 18031 (California Personal Income Tax) and 24941 (California Corporation Tax), when the seller/transferor is relieved of a liability in a like-kind exchange, unless the seller/transferor also assumes an equal or greater liability as part of the like-kind exchange. (See Treas. Reg. §§ 1.1031(a)-1, 1.1031(b)-1, and 1.1031(d)-2.) As a result, the phrase "including excess debt relief" must be retained since removing such language would be contrary to the law which requires that withholding occur when gain is recognized. In regard to liabilities, gain

must be recognized when debt relief is in excess of the amount of debt assumed in a like-kind exchange.

Finally, the phrase "withholding is required" cannot be removed because pursuant to RTC Sections 18662(e)(3)(B) and 18662(e)(3)(D)(ii)(I), in an IRC Section 1031 exchange, an intermediary or accommodator must withhold when there is gain that the seller/transferor is required to recognize (as set forth above).

Accordingly, no changes to the Regulations were made as a result of the written public comment.

## **ALTERNATIVES DETERMINED**

The FTB has determined that no alternative to the proposed Regulations it considered would be more effective in carrying out the purpose of the proposed Regulations or would be as effective and less burdensome to affected private persons than the adopted Regulations, or would be more cost effective to affected private persons and equally effective in implementing the statutory policy or other provisions of the law, in accordance with Government Code Section 11346.9, subdivision (a)(4). The proposed Regulations are the only text identified by or proposed to the FTB that accomplishes the intent of the Regulations and no alternatives have been identified or proposed that would reduce costs to those regulated.

## **ALTERNATIVES THAT WOULD LESSEN ADVERSE ECONOMIC IMPACT ON SMALL BUSINESS**

The FTB has determined that the proposed amendments will not have a significant impact on small business. The FTB estimates that at most 1,000 businesses might be impacted by changes to the proposed Regulations and that a majority of these may be small businesses. However, the number of small businesses represents only a minor share of total small business entities doing business in California. In addition, the amendments to the proposed Regulations alter the amount of withholding remittance payments but do not change the amount of tax owed by small businesses in any given tax year. The remittance changes versus the status quo would be offset when the business files their final tax return. Thus for any given tax year, the impact on small businesses will be negligible.

Accordingly, the FTB has determined that there were no alternatives considered which would be more effective in carrying out the purpose of the proposed amendments, or would be less burdensome with respect to small businesses than the proposed Regulations amendments. Further, the FTB has determined in an economic impact statement and relies on the conclusions therein, that the economic impact, including the ability of California businesses to compete with businesses in other states, will not be significant.

## **LOCAL MANDATE DETERMINATION**

The proposed Regulations do not impose any mandate on local agencies or school districts.