

## Franchise Tax Board

## ANALYSIS OF ORIGINAL BILL

Author: Stone Analyst: Janet Jennings Bill Number: SB 352  
Related Bills: See Legislative History Telephone: 845-3495 Introduced Date: February 14, 2017  
Attorney: Bruce Langston Sponsor: \_\_\_\_\_

**SUBJECT:** Withholding/Nonresident Real Property

### SUMMARY

This bill would modify the withholding requirement relating to sales of real property under the Administration of Franchise and Income Tax Laws.

### RECOMMENDATION – NO POSITION

### REASON FOR THE BILL

The reason for the bill is to eliminate existing withholding requirements and instead, require withholding of  $3\frac{1}{3}$  percent of the sales price of the property if the property was either acquired from a person (other than a partnership), or a corporation that no longer has a connection to the state.

### EFFECTIVE/OPERATIVE DATE

This bill would be effective January 1, 2018, and would be specifically operative with respect to dispositions of California real property interests that occur on or after January 1, 2018.

### FEDERAL/STATE LAW

Both federal and state law require tax prepayment of the estimated annual tax to be paid on income, either through withholding or by making estimated tax payments.

Under federal law, a percentage of income paid to a nonresident alien or a foreign corporation for services or sale of real property must be withheld. The withholding obligation is imposed on the withholding agent. A withholding agent means the person that is normally responsible for the disbursement of the funds. The withholding agent is frequently the person paying for the services or purchasing the property, but can also be an attorney, escrow person, broker, or other intermediary.

A penalty is imposed if the withholding agent fails to withhold from a nonresident alien or foreign corporation. The amount of the federal penalty is equal to the amount of tax the taxpayer ultimately fails to pay, but cannot exceed the amount that should have been withheld. Therefore, the penalty can be assessed only after the Internal Revenue Service (IRS) determines the amount of tax the taxpayer failed to pay. The penalty is excused if the failure to withhold is due to reasonable cause.

California law is similar to federal law except California law expands withholding to any disposition from the sale or exchange of California real property by a seller, unless when the transferor is a bank acting as a trustee, other than a trustee of a deed of trust, or an exemption certificate on FTB Form 593-C, Real Estate Withholding Certificate, is completed, signed and submitted verifying the withholding is not required. Real estate withholding is a prepayment of the income (or franchise) tax due on the gain from the sale of California real property.

For real property, California law requires withholding of  $3\frac{1}{3}$  percent (.0333) of the sales price of California real property. Alternatively a transferor may elect to have withholding calculated as the amount equal to the gain on the sale of California property required to be recognized on the tax return, as certified under penalty of perjury by the transferor, multiplied by the rate specified.

Withholding is not required on sales or transfers of California real property when:

- The total sales price does not exceed \$100,000,
- The transferor is a bank acting as a trustee other than a trustee of a deed of trust,
- The property is being foreclosed upon when the transferee acquires California real property under one of the following circumstances: (1) at a sale pursuant to a power of sale under a mortgage or deed of trust, (2) at a sale pursuant to a decree of foreclosure, or (3) by a deed in lieu of foreclosure, or
- The transaction meets one of the following exemptions where the transferor must sign a written certification under penalty of perjury to be exempt from withholding:

Certifications which fully exempt the sale from withholding:

- The property qualifies as the transferor's principal residence within the meaning of Internal Revenue Code (IRC) section 121,
- The property was last used as the transferor's principal residence within the meaning of IRC Section 121 without regard to the two-year time period,
- The sale will result in a loss or zero gain for California income tax purposes,
- The property is being compulsorily or involuntarily converted and the transferor intends to acquire property that is similar or related in service or use to qualify for nonrecognition of gain for California income tax purposes under Internal Revenue Code (IRC) section 1033,
- The transfer qualifies for nonrecognition treatment under IRC section 351 (transfer to a corporation controlled by the transferor) or IRC section 721 (contribution to a partnership in exchange for a partnership interest),
- The transferor is a corporation (or a limited liability company (LLC) classified as a corporation for federal and California income tax purposes) that is either qualified through the California Secretary of State or has a permanent place of business in California,
- The transferor is a California partnership or a partnership qualified to do business in California (or an LLC that is classified as a partnership for federal and California income tax purposes and is not a single member LLC that is disregarded for federal and California income tax purposes),

- The transferor is a tax-exempt entity under California or federal law, or
- The transferor is an insurance company, individual retirement account, qualified pension/profit sharing plan, or charitable remainder trust.

Certifications that may partially or fully exempt the sale from withholding:

- The transfer qualifies as a simultaneous like-kind exchange within the meaning of IRC section 1031,
- The transfer qualifies as a deferred like-kind exchange within the meaning of IRC section 1031, or
- The transfer of the property is an installment sale where the transferee is required to withhold on the principal portion of each installment payment.

An exemption certificate from withholding does not eliminate the requirement to file a tax return or pay the tax due.

Current law specifies when and how amounts withheld must be reported and remitted to the Franchise Tax Board (FTB) and imposes a penalty for a failure to withhold that is equal to the greater of \$500 or 10 percent of the amount required to be withheld. The penalty may be abated if the failure to withhold is due to reasonable cause.

## **PROGRAM BACKGROUND**

Real estate withholding is a prepayment of the income or franchise tax due from sellers of California real property. The real estate withholding prepayment is due to the FTB by the 20<sup>th</sup> day of the month following the month escrow closes. The seller then claims the real estate withholding prepayment as a payment against the tax due on the return. Real estate withholding does not relieve sellers from the requirement to file a tax return. Even if the seller is exempt from the real estate withholding requirements, they may still owe California taxes or have a requirement to file a California tax return. Absent real estate withholding, sellers of real property may be subject to the requirement to pay estimated taxes.

## **THIS BILL**

This bill would, in the case of any disposition of a California real property interest on or after January 1, 2018:

- Make inoperative the existing withholding requirements relating to the sale of real property interests, including the ability to elect an alternative to the withholding requirement based on a percentage of the sales price.
- If not otherwise exempt, require the transferee of a real property interest to withhold  $3\frac{1}{3}$  percent (.0333) of the sales price of the property if the property was either acquired from a person who is a broker required to file a return pursuant to IRC section 6045(e) or who authorizes disbursement of proceeds to a transferor whose last known street address at the time of the transfer of the title is outside the state or from a corporation, if immediately after the transfer of title to the California real property, that corporation has no permanent place of business in this state. A corporation would have no permanent place of business in this state if all of the following apply:

- It is not organized and existing under the laws of California.
- It is not qualified with the office of the Secretary of State to transact business in California.
- It does not maintain and staff a permanent office in California.
- Exempt partnerships from the new withholding requirements by specifically providing that “person” excludes a partnership as determined in accordance with Subchapter K of Chapter 1 of Subtitle A of the IRC.

## **IMPLEMENTATION CONSIDERATIONS**

Implementing this bill would not significantly impact the department’s programs and operations.

## **TECHNICAL CONSIDERATIONS**

This bill inadvertently excludes an intermediary or accommodator in a deferred exchange from the requirement to withhold. The bill should be amended to include clarifying language that specifies that the withholding requirements, in the case of property disposition by a person or corporation, on or after January 1, 2018, would apply to any intermediary or accommodator in a deferred exchange.

For clarity and internal consistency, it is recommended that line 7 on page 5 be amended to read "it does not qualify with the office of the Secretary of State."

The present withholding regime is dependent on two provisions working together: (1) imposition of withholding requirements,<sup>1</sup> and (2) penalties relating to withholding provisions.<sup>2</sup> To maintain this relationship, the existing statute that specifies language that must be included in written notifications of withholding requirements should be amended.

## **LEGISLATIVE HISTORY**

AB 495 (Stone 2015/2016) was substantially similar to this bill. AB 495 failed to pass out of the Assembly Appropriations Committee.

AB 3078 (Committee on Revenue and Taxation, Chapter 305, Statutes of 2008), among other things, requires non-California partnerships to withhold on California real property dispositions 3 $\frac{1}{3}$  percent of sales proceeds or 9.3 percent of the gain on the disposition.

AB 2962 (Benoit, Chapter 428, Statutes of 2006) allows transferors of California real property to elect an alternative to the withholding requirement based on a percentage of the sale price. The election requires the transferor to certify the withholding amount in writing under penalty of perjury. AB 2962 was implemented to correct over-withholding on the sale of California real property interests.

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<sup>1</sup> Revenue and Taxation Code (R&TC) section 18662.

<sup>2</sup> R&TC section 18668.

AB 1338 (Chávez, Chapter 528, Statutes of 2004) revised withholding requirements for corporations with no permanent place of business in California to conform to the withholding requirements for individual transferors, clarified that transfers of real property to controlled corporations and partnerships are contributions to capital, and excluded sales of a decedent's principal residence by estates from withholding.

AB 2065 (Oropeza, Chapter 488, Statutes of 2002), among other things, expanded withholding requirements to residents and converted the waiver process into a self-certification process. Prior to AB 2065, the withholding requirements on the sale of California real property interests applied to nonresidents and corporations that have no permanent place of business in this state after the transfer.

### **OTHER STATES' INFORMATION**

The states surveyed include *Florida, Illinois, Massachusetts, Michigan, Minnesota, and New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. No statutes imposing a withholding requirement on dispositions of real property were identified. However, nonresidents of *New York* must compute the gain (or loss) and pay any estimated personal income tax due from the sale or transfer of certain real property, including cooperative units.

### **FISCAL IMPACT**

The department's costs to implement this bill have yet to be determined. As the bill moves through the legislative process, costs will be identified and an appropriation will be requested, if necessary.

### **ECONOMIC IMPACT**

#### **Revenue Estimate**

This bill would result in the following revenue loss:

Estimated Revenue Impact of SB 352 As Introduced February 14, 2017 Assumed Enactment After June 30, 2017 (\$ in Millions)		
2017-18	2018-19	2019-20
- \$340	- \$410	- \$70

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill.

#### **Revenue Discussion**

The bill does not change the amount of tax due; it only changes the timing of tax payments. Based on the FTB's real estate withholding data adjusted for changes in the economy over time, approximately \$1.2 billion in 2018 would be collected as real estate withholding under current law. Using zip code data from California real estate sales, it is estimated that

15 percent of sales are executed by nonresidents and thus would be subject to withholding of  $3\frac{1}{3}$  percent. As a result, the remaining \$1 billion that would have been withheld on sales by residents, and partnerships under current law in 2018 would be due in 2019.

It is assumed that 95 percent of the amount, or \$950 million, would be paid in the first two years, 25 percent in the year of the sale and the remaining 75 percent before the due date of the return. The remaining 5 percent would be subject to collection actions. The change in timing of the payments results in an estimated revenue loss of \$700 million in 2018 and \$80 million in 2019.

The taxable year estimates are converted to fiscal year estimates, rounded to arrive at the amounts in the table above.

### **SUPPORT/OPPOSITION**

Support: None on file.

Opposition: None on file.

### **ARGUMENTS**

Proponents: Some may say that withholding at a standard rate of  $3\frac{1}{3}$  percent of the sales price would improve compliance among nonresident individuals and corporations lacking presence in California.

Opponents: Some may argue that standard rate withholding could result in over-withholding that an election to use an alternate withholding method would resolve.

### **POLICY CONCERNS**

This bill would eliminate the withholding requirement on partnerships upon the disposition of California real property sales, yet keep the requirements for certain individuals and corporations. Thus, this bill would favor partnerships.

This bill would remove the existing provision, enacted to correct for over-withholding, that allows transferors to elect to compute withholding based on the gain from the sale instead of a percentage of the sales price. If this bill is enacted, the transferor would be unable to elect an alternate withholding computation that may more accurately reflect the tax due on the gain. For example, a transferor that sells a real property interest for \$300,000 that results in a gain of \$1 would be required to withhold  $3\frac{1}{3}$  percent of the sales price, \$9,999 ( $\$300,000 \times 3\frac{1}{3}\%$ ).

Eliminating withholding on dispositions of property by a partnership or California resident may trigger an estimate payment requirement that would otherwise not exist and could result in the imposition of penalties on taxpayers that fail to remit a required estimate payment.

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