



## Analysis of Original Bill

Author: AR&T Committee      Sponsor: Franchise Tax Board      Bill Number: AB 3372  
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Attorney: Shane Hofeling      Related Bills: See Legislative  
History

## SUBJECT

Electronic Continuous Order to Withhold/Water's-Edge Election & Doing Business

## SUMMARY

### *Provision No. 1: Electronic Continuous Order to Withhold*

This bill, under the Administration of Franchise and Income Tax Law (AFITL), would allow electronic delivery of continuous orders to withhold (COTW), and related notices or documents, for notices filed or served on or after enactment of this bill.

### *Provision No. 2: Water's-Edge Election & Doing Business*

This bill, under the Corporation Tax Law, would amend the water's-edge election law to maintain an otherwise-valid water's-edge election if a unitary foreign affiliate becomes a taxpayer solely due to California's "doing business" statute.

## RECOMMENDATION

Support.

On December 3, 2019, the three-member Franchise Tax Board voted 2-0, with Deputy-Member Gayle Miller, Department of Finance abstaining, to sponsor this language.

## SUMMARY OF AMENDMENTS

Not applicable.

## REASON FOR THE BILL

### *Provision No. 1: Electronic Continuous Order to Withhold*

The reason for this provision is to allow the Franchise Tax Board (FTB) to use electronic service for COTWs and related notices and documents.

*Provision No. 2: Water's-Edge Election & Doing Business*

The reason for this provision is to prevent the unintended termination of a water's-edge election when a unitary foreign affiliate of a water's-edge combined reporting group subsequently becomes a taxpayer because it is "doing business" in California.

**ANALYSIS**

Since this bill contains two distinct provisions, an analysis is being completed separately for each.

***Analysis Provision No. 1: Electronic Continuous Order to Withhold (Bill Section 1)***

This provision would provide the FTB the ability to serve or file COTW notices or documents by electronic transmission or other electronic technology, in addition to the current requirement to serve or file these notices personally or by first-class mail.

*Effective/Operative Date*

If enacted by September 30, 2020, this bill would become effective January 1, 2021, and would be applicable to notices filed or served on or after that date. If enacted after September 30, 2020, this bill would become effective January 1, 2022, and would be applicable to notices filed or served on or after that date.

*Federal/State Law*

*Federal Law*

Internal Revenue Code section 6331 provides that the Treasury Secretary may authorize collection of tax by levy, including levies on salary or wages, when any person liable to pay any tax neglects or refuses to pay after notice and demand.

Under current federal law, the Internal Revenue Services' wage garnishments may be sent to the employer by first-class mail or served in person.

Federal law requires that wage garnishments for federal employees be sent via certified or registered mail, return receipt requested, or by personal service to either the head of the federal employee's agency, as defined, or the agency's designated agent. (See Section 5 United States Code 5520a(c)(1)).

### *State Law*

Generally, under the Code of Civil Procedure (CCP), current state law limits service of COTWs, earnings withholding orders for taxes (EWOTs), and earnings withholding orders (EWOs), and any other notice or document required in connection with these notices, to first-class mail or in-person service.

There are exceptions under Family Code sections 5246(h) and 17454(d), which allow a local child support agency to transmit an order or notice to withhold income for child support, and other related, required forms, through electronic means, and allow the Department of Child Support Services to serve a notice to withhold by magnetic media, electronic transmission, or other electronic technology, respectively.

Revenue and Taxation Code (R&TC) section 18671 specifically limits service of the FTB's COTWs to first-class mail or in-person delivery.

### *Implementation Considerations*

Implementing this provision would require the modification of some systems, taxpayer education and outreach efforts, the revision of procedures and existing tax forms and instructions, and staff training to respond to questions regarding the electronic service of COTWs, which could be accomplished during the normal annual update.

### *Technical Considerations*

On page 3, lines 23-24, strike out "electronic transmission, or", and insert "or by electronic transmission or".

R&TC section 18671 governs the rules related to COTWs. Article 4 (commencing with Section 706.070) of Chapter 5 of Division 2 of Title 9 of Part 2 of the CCP governs the rules relating to withholding orders for state tax liabilities not paid, including EWOTs and EWOs, by reference of R&TC section 19280, levied by the FTB. Implementing the section as drafted could have unintended consequences. Amending the areas of law that relate to COTWs, EWOTs and EWOs is recommended. Specifically, amending R&TC section 19264 to incorporate EWOTs and EWOs would ease implementation, ensure that the author's intent is fulfilled, and avoid potential unintended consequences.

### *Policy Concerns*

This provision is specific to the FTB. The author may wish to consider expanding this provision of the bill to authorize electronic communication methods for other state agencies serving OTAs and COTWs and request the FTB to work cooperatively with our external partners and sister agencies for statutory parity.

## LEGISLATIVE HISTORY

AB 1720 (AR&T Comm, Chapter 177, Statutes of 2017) extended taxpayers the choice to electronically communicate with the FTB until January 1, 2025.

AB 2754 (AR&T Comm, Chapter 478, Statutes of 2014) required certain business entities to e-file tax returns unless a waiver is granted.

## PROGRAM BACKGROUND

Since the mid-1990s, the internet has had a revolutionary impact on culture, commerce, and technology, including the rise of near-instant communication by electronic mail, instant messaging, voice over internet protocol (VoIP) telephone calls, two-way interactive video calls, and the World Wide Web with its discussion forums, blogs, social networking, and online shopping sites. In addition, e-services are now available through mobile devices.

As a result of changes in technology, citizens are increasing their interest in conducting business through electronic means, including engaging with government through their smart phones or other electronic means. California state and local governmental entities continue to increase services offered electronically, including vehicle registrations, required filings, and payments.

### FTB's Electronic Services

The FTB began receiving electronic payments in 1994 with the implementation of the requirement for certain corporations to pay by Electronic Funds Transfer (EFT). R&TC section 19011 requires payments by EFT when a corporation's estimated tax payments or total tax liability exceed certain thresholds, or upon an approved request to the FTB. R&TC section 19011.5 requires payments received after January 1, 2009, to be made electronically for individuals when estimated tax payments or total tax liability exceed certain thresholds.

The FTB also began processing electronically-filed (e-filed) tax returns in 1994. The requirement for e-filing began in 2004 for tax preparers of individual income tax returns, and the e-filing requirement for "business entities" began in 2014. R&TC section 18621.9 requires tax preparers that prepare over 100 California individual income tax returns in any calendar year beginning January 1, 2003, or after, and in the following calendar year prepare one or more individual returns using tax preparation software, to file thereafter using electronic technology. R&TC section 18621.10 requires business entity returns that were prepared using a tax preparation software, to be filed using electronic technology. A business entity is defined as a corporation, including an S corporation, an exempt organization, a partnership, or a limited liability company.)

Over time, the percentage of e-filed returns has continued to grow, and in 2018, 84 percent of personal income tax returns and 81 percent of business entity returns received by the FTB were e-filed, indicating increased acceptance and comfort with the electronic filing process.

### Collection Tools

#### *State Tax Liens*

A state tax lien attaches to a taxpayer's real or personal property and expires in ten years unless a notice of the state tax lien is recorded. After recording a notice of state tax lien, the FTB's statutory lien is extended for the duration of the recorded lien. Under the "E-Lien" process, the FTB issues orders and other documents related to real property liens by electronic means to counties that have applicable technology. R&TC section 19221 provides for the enforcement of a state tax lien when a taxpayer fails to pay a tax liability. Government Code section 27279 allows the FTB to record a notice of state tax lien with the applicable county recorder. The notice may be filed by electronic means if the technology is available to the county.

#### *Orders to Withhold*

An order to withhold (OTW) is a demand to a third party in possession of funds or properties belonging to a taxpayer that fails to pay certain liabilities to pay such funds to the FTB. The OTW can attach to checking or savings accounts, vacation trust funds, or safety deposit boxes. An OTW levies 100 percent of available funds when the order is received, not to exceed the amount of the order. It is a one-time order that allows the FTB to collect tax liabilities, court-ordered debt, and vehicle registration assessments.

In 2013, the FTB began using an "E-Levy" process to issue OTWs to depository institutions. Under this process, the financial institution receives the OTW electronically, notifies the account holder by written notice, and remits payment electronically to the FTB within ten business days.

#### *Continuous Order to Withhold*

A COTW is a demand directed against any credit or payment due, or becoming due, to a taxpayer with certain uncollected liabilities or enforceable obligations. It can be directed against:

- Services performed as an independent contractor, dividends, rents, royalties, residuals, patent rights, mineral or other natural resource rights.
- Services or sales, as a result of written or oral contracts, whether designated as wages, salary, commission, bonus, or other designation.

A COTW can levy a maximum of 25 percent of each payment due to the taxpayer.

### *Earnings Withholding Order for Taxes and Earnings Withholding Order*

An EWOT or EWO is a notice sent to an employer when an individual or business entity taxpayer has a balance due, following the issuance of required notices of tax due. (In the case of a taxpayer that is an independent contractor, the EWOT or EWO is mailed to the payer of the Independent Contractor Agreement (referred to as an employer for purposes of this discussion.)

Currently, the FTB's EWOTs and EWOs, and related modifications, terminations, and releases are sent by first-class mail to the taxpayer's employer. Similarly, the employer's communication with regard to the FTB's EWOTs and EWOs are done via the United States Postal Service.

Legislation enacted R&TC section 19264 in 1996 that authorized the FTB to establish a pilot program to issue EWOTs and EWOs to employers using magnetic media, electronic transmission, or other electronic technology. However, system limitations at that time within the FTB and with employers precluded the implementation of this pilot project.

#### **FISCAL IMPACT**

Dependent on the reduction of COTW mailing levels, FTB staff estimates that there could be a cost savings from postage. Any staff time savings as a result of this change would be absorbed in other revenue producing collection efforts.

The implementation efforts for this provision would be included in the department's current technology modernization effort (Enterprise Data to Revenue 2 (EDR2)) planned to start in July 2021. The FTB is currently engaged in the Project Approval Lifecycle to request vendor services to assist in the modernization of the technology that supports the Accounts Receivable Management Program.

As the bill moves through the legislative process, estimated cost savings and costs will be identified.

#### **ECONOMIC IMPACT**

##### *Revenue Estimate*

There is no revenue impact for this provision of the bill.

This proposal would not change the manner in which income or franchise tax is calculated under the R&TC. However, it would create other methods for the service of COTWs.

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill or for the net final payment method of accrual.

*Revenue Discussion*

This bill would allow, in addition to current methods, the ability to serve, terminate, modify or release COTWs as well as the receipt of employer's returns, as it relates to COTWs, by electronic transmission or other electronic technology. The FTB does not anticipate a change in the collection of debts as a result of the additional service methods and therefore no anticipated revenue impact to the General Fund.

**LEGAL IMPACT**

None noted.

**APPOINTMENTS**

None noted.

**SUPPORT/OPPOSITION**

*Support*

The three-member Franchise Tax Board.

*Opposition*

To be determined.

**ARGUMENTS**

To be determined.

***Analysis Provision No. 2: Water's-Edge Election & Doing Business (Bill Section 2)***

This proposal would eliminate the uncertainty arising from the unintended consequences of California's "doing business" statute on a valid water's-edge election by maintaining an otherwise-valid water's-edge election when a unitary foreign affiliate becomes a taxpayer solely due to California's "doing business" statute.

### Effective/Operative Date

If enacted by September 30, 2020, this bill would become effective January 1, 2021, and operative for taxable years beginning on or after January 1, 2021. If enacted after September 30, 2020, this bill would become effective January 1, 2022, and operative for taxable years beginning on or after January 1, 2021.

### Federal/State Law

#### Federal Law

There is no comparable provision in federal law.

#### State Law

Unless a corporate taxpayer makes a water's-edge election, it must use the worldwide combined reporting method to file its state taxes, and its unitary business income from both domestic and foreign operations is considered in the calculation of state tax. A share of that business income is apportioned to California. The amount to be apportioned to California is determined by a formula. In general, the formula measures relative levels of business activity in the state using a single-sales factor. The single-sales factor from both domestic and foreign activities is used in the calculation of the apportionment formula. (For taxable years beginning on or after January 1, 2013, all apportioning trade or businesses, except those that derive more than 50 percent of their gross receipts from qualified business activities, shall apportion their business income to California using a single-sales factor.)

In addition to the single-sales factor method for determining California income, some taxpayers can use a three- or four-factor method for the apportionment formula. This formula considers the taxpayer's California and worldwide property, payroll, and sales. (When using the four-factor method, the taxpayer's sales factor is doubled.)

As an alternative to the worldwide combined reporting method, California law allows corporations to elect to determine their business income on a "water's-edge" basis. Every member of the self-assessed combined reporting group that is subject to California taxation (i.e., all taxpayer members) must make a water's-edge election. Current law provides that a unitary foreign affiliate of a water's-edge combined reporting group that, at the time of the election, is not "doing business" in this state, and thus, is not a taxpayer, cannot make a water's-edge election with the combined reporting group.

The initial term of a water's-edge election is 84 months and remains in effect thereafter, year to year, until terminated. Before expiration of the initial 84-month period, the taxpayer may request the FTB consent to terminate the water's-edge election. If a water's-edge election is terminated, the taxpayer is required to file on a worldwide basis for at least 84 months before making another water's-edge election.



State law addresses the effect on water's-edge elections resulting from changes in the composition of the water's-edge combined reporting group due to corporate events such as acquisitions, mergers, consolidations, or disqualifications between electing and non-electing affiliates that occur after a valid election is made. (R&TC section 25113(c)(5)(A)-(D).) In certain situations, a non-electing taxpayer will be "deemed" to have made a water's-edge election. For example, a corporation that was a non-taxpayer member of the water's-edge combined reporting group that subsequently becomes a California taxpayer, will be deemed to have made the water's-edge election with other taxpayer members of the water's-edge combined reporting group. (R&TC section 25113(b)(4).) Neither state law nor regulations expressly address the impact on a water's-edge election as a result of a law change that changes the status of a non-electing unitary foreign affiliate from non-taxpayer to taxpayer.

### Doing Business

State law, for taxable years beginning before January 1, 2011, defined "doing business" for franchise tax purposes as actively engaging in any transaction for the purpose of financial or pecuniary gain or profit. R&TC section 23151 provides that every corporation "doing business" within California and not expressly exempted from taxation by the provisions of the California Constitution, must annually pay tax in California.

For taxable years beginning on or after January 1, 2011, the definition of "doing business" was amended by adding the following "bright-line" tests. (R&TC section 23101, as amended by SBX3-15 (Calderon, Chapter 17, Statutes of 2009).) Meeting any one of the following thresholds is sufficient for the corporation to be "doing business" and therefore subject to tax in California unless otherwise excepted:

- The taxpayer is organized or commercially domiciled in this state.
- Sales of the taxpayer in California exceed the lesser of five hundred thousand dollars (\$500,000), adjusted annually for inflation, or 25 percent of total sales. (Sales, as defined in subdivision (e) or (f) of R&TC section 25120. Sales of the taxpayer include sales by an agent or independent contractor of the taxpayer. Additionally, sales in this state shall be determined using the rules for assigning sales under R&TC section 25135 and subdivision (b) of R&TC section 25136 and the regulations thereunder as modified by regulations under section 25137. Thus, a foreign affiliate may have sales assigned to California under California's market-based sourcing rules. For taxable year 2016, the adjusted sales amount is \$547,711.)

- Real property and tangible personal property of the taxpayer in California exceed the lesser of fifty thousand dollars (\$50,000), adjusted annually for inflation, or 25 percent of the taxpayer's total real and tangible personal property. (The value of the property and the determination of whether property is in this state shall be determined using the rules contained in R&TC sections 25129 to 25131, inclusive, and the regulations thereunder, as modified by regulation under section 25137. For taxable year 2016, the adjusted property amount is \$54,771.)
- The amount paid in compensation by the taxpayer in California exceeds the lesser of fifty thousand dollars (\$50,000) or 25 percent of the total compensation paid by the taxpayer. (Compensation in this state shall be determined using the rules for assigning payroll contained in section 25133 and the regulations thereunder, as modified by regulations under section 25137. For taxable year 2016, the adjusted property amount is \$54,771.)

The sales, property, and payroll of the taxpayer include the taxpayer's pro-rata or distributive share of pass-through entities, which include a partnership or an S corporation.

#### Market-Based Sourcing Rules for Sales Other Than Sales of Tangible Personal Property

State law requires that a taxpayer use the market-based sourcing rules, for purposes of determining sales under the "doing business" factor-presence test, discussed above.

Under market assignment, sales of services and sales of intangible property are assigned based on the location of the taxpayer's market. In general, sales are assigned to the California sales factor numerator as follows:

- Sales from services are in California to the extent the purchaser of the service received the benefit of the services in California.
- Sales from intangible property are in California to the extent the property is used in California. In the case of marketable securities, sales are in California if the customer is in California.
- Sales from the sale, lease, rental, or licensing of real property are in California if the real property is located in California.
- Sales from the rental, lease, or licensing of tangible personal property are in California if the property is located in California.

#### *Implementation Considerations*

Implementing this provision would require taxpayer education and outreach efforts, and revisions to existing tax forms and instructions, which could be accomplished during the normal annual update.

### *Technical Considerations*

None noted.

### *Policy Concerns*

None noted.

## **LEGISLATIVE HISTORY**

SB 567 (Lara, 2017/2018), as introduced would have, among other things, sunset the water's-edge method of filing. SB 567 was subsequently amended and the water's-edge sunset provision was removed from the bill. SB 567 failed to pass by the constitutional deadline.

## **PROGRAM BACKGROUND**

The FTB issued two notices temporarily bridging the gap between the unintended consequences of the amended "doing business" statute and its potential impact on water's-edge elections. The notices provide, subject to specified conditions, that the FTB will not terminate an otherwise-valid water's-edge election of a water's-edge combined reporting group that is unitary with a foreign affiliate that becomes a taxpayer solely by application of California's amended "doing business" statute. In general, the notices apply the deemed election provisions of R&TC section 25113(b)(4). (FTB Notice 2016-02, issued September 9, 2016, pertains to water's-edge elections made before September 9, 2016, for unitary foreign affiliates that became California taxpayers in a taxable year beginning on or before December 31, 2016. FTB Notice 2017-04, issued October 16, 2017, extends the guidance provided in FTB Notice 2016-02, for unitary foreign affiliates that become California taxpayers in a taxable year beginning on or before December 31, 2017.)

The "doing business" statute had unintended consequences related to water's-edge elections when a non-electing unitary foreign affiliate subsequently changes status from a non-taxpayer to a California taxpayer as a result of the revised definition of "doing business." Thus, changing the composition of the water's-edge combined reporting group after the election is made.

California law allowing water's-edge elections lacks clarity regarding the effect on an otherwise-valid water's-edge election when a change in status from a non-taxpayer to a taxpayer is due solely to the definitional change in R&TC section 23101(b). FTB Notices 2016-02 and 2017-04, subject to specified conditions, apply the deemed election provision to maintain an otherwise-valid water's-edge election, thereby, temporarily bridging the gap between the unintended consequences of the "doing business" statute and FTB's obligation to respect the intent of the water's-edge statute.

Note that representatives of the State Bar of California presented a 2017 Sacramento Delegation Paper recommending that R&TC section 25113 be amended to “fairly reflect the intent of the water’s-edge election and account for the new foreign affiliate taxpayer.” The representatives state that a “long term statutory solution is needed to eliminate ambiguity and provide clear guidance in 2017 and beyond.

## **FISCAL IMPACT**

This provision would not significantly impact the department’s costs.

## **ECONOMIC IMPACT**

### *Revenue Estimate*

The revenue impact of this provision cannot be determined at this time.

This analysis does not account for changes in employment, personal income, or gross state product that could result from this bill or for the net final payment method of accrual.

### *Revenue Discussion*

To determine the magnitude of confirming/terminating a water’s-edge election, both the frequency of the water’s-edge election confirmation/termination and the value of the foreign business factors would need to be known. Because it is difficult to predict the frequency and the value of water’s-edge versus worldwide business activities, the FTB lacks the necessary data, and as a result, the revenue impact is unknown.

The revenue impact of the proposal would be estimated by comparing the tax liabilities of the members of a unitary group under two different paradigms. First using current law, where the water’s-edge election is terminated and the unitary group is taxed under the worldwide reporting system, taking into account the apportionment factors of all the corporations in the unitary group. Then using the changes as proposed in this provision, where the water’s-edge election remains valid and the non-electing member is deemed to have elected with the original water’s-edge group.

To date the Department has not terminated a water’s-edge election for a taxpayer with a foreign non-electing member that has been found to have nexus in California. To estimate the revenue impact of this provision, FTB would need to re-calculate the apportionment factors and aggregate incomes of the members of the unitary groups with and without the water’s-edge election. To do this FTB would need the taxable income and apportionment factors for each of the entities deemed to have nexus in California and would be included in the water’s-edge and worldwide combined reports. Because the FTB does not have the data needed for a representative sample, it lacks the ability to complete an analysis. However, it is assumed that a change in

the apportionment factors could result in some members of the unitary group paying more tax and some members paying less tax. As a result, the revenue impact could be positive, negative, or zero.

### **LEGAL IMPACT**

None noted.

### **APPOINTMENTS**

None Noted.

### **SUPPORT/OPPOSITION**

#### *Support*

The three-member Franchise Tax Board.

#### *Opposition*

To be determined.

### **ARGUMENTS**

To be determined.

### **Legislative Staff Contact**

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