

Summary of Interested Parties Meeting
Proposed Regulation § 18662-7, Pass-Through Entity Withholding

- I. **Administration:** On December 12, 2014 at approximately 1:00 p.m., members of the public attended an interested parties meeting at the Franchise Tax Board central office in Sacramento. Parties attended in person and by telephone. Those physically present were asked to register at the entrance and those on the telephone were asked to fax a business card to Teresa Bush-Chavey for later correspondence. Phone participants introduced themselves. The session was to be tape-recorded for reference but there would be no attribution of comments and no transcript.

The Hearing Officer, Leah Thyberg, listed the two documents available as handouts: notice of the meeting as well as the tiered structure handout. Parties were told they had until January 30, 2015 to submit written comments.

The purpose of the meeting was discussed as being a time for the public to provide comments on the issues arising with pass-through entity withholding. Discussion then proceeded through the discussion topics.

- II. **Discussion:** The discussion was organized topically, covering the following four areas:

1. Withholding on distributive share of income:

It was discussed that California is interested in switching to requiring withholding on a partner's distributive share of partnership income. Thirty-three states require pass-through entities to withhold from distributive share of income, while only four states require withholding from actual partnership distributions made. Comments included the following:

- Will the switch to requiring withholding on distributive share of income be prospective, and from what date?

Response: It is thought that the regulation will definitely be prospective in operation, but staff is unsure when that date will be (the final regulation may not be in place until 2017).

- Is there a particular model being focused on?

Response: There is no particular model being looked at. The main purpose of the meeting is to elicit discussion to see which state schemes are preferred by the interested parties, and why those schemes are preferred.

- Is there going to be a de minimus level for withholding? It is often difficult to complete an out of state return for a de minimus refund when there is withholding on small amounts of distributive share pass-through income.

Response: FTB staff will discuss this in the future. There is no scheme to be proposed today, other than the general plan to move to withholding on distributive share of income. FTB staff will meet with program staff to evaluate what withholding scheme the current system can handle.

- Will this pass-through entity withholding scheme remain separate from the other withholding schemes, for example withholding on foreign partners, or non-consenting LLCs? May want to consider how withholding will impact the other withholding schemes.

Response: What would you recommend? Consolidate, or remain separate? FTB staff will look into this further.

2. Pass-Through Entity Withholding Forms and Allocation of Withholding:

It was discussed that pass-through entities, tiered structures in particular, have difficulty in timely filing Form 592 to allocate withholding to the ultimate owner. More specifically, it appears that an upper tier pass-through entity may not receive its withholding information from the lower tier pass-through entity (typically through Form 592-B) until after the Form 592 quarterly due date. Additionally, sometimes pass-through entities' tax preparers do not receive the Form 593, reporting real estate withholding, until after the Form 592 quarterly due date.

One example of how other states handle this issue is Michigan, which now requires a Form 4918, California's Form 592 equivalent, to be filed once a year by 02/28 in order to allocate withholding. The Withholding Statements, which are California's Form 592-B equivalent, are sent by the withholding agent to those that it made withholding payments on behalf of, due no later than 1/31. This then allows the upper tier pass-through entity one month from receiving the

withholding statement to file their own Form 4918 to allocate the withholding by the 2/28 deadline.

The positive of this approach is that it allows more time for withholding to be allocated through tiered pass-through entity structures. However, a potential issue arising from this is the possibility of allowing too much time for allocating withholding. There would be an increased risk of individuals claiming their withholding credit on their income tax returns before the withholding credit has been allocated. An advantage to Michigan's approach is that this could help with the Form 593 issue, where tax preparers are not receiving the pass-through entities' Form 593 until after the Form 592 due date. With Michigan's approach, the tax preparers receive Form 593 as well as Form 592-B before the annual Form 592 due date. Comments included the following:

- Does FTB want to divide Form 592 from Form 593 in the regulation, or bring them together? Escrow agents should send these to the sellers with closing agreements. The 1/31 deadline is reasonable. However, there may be issues with tiered structures and all of the layers. Will there be references to each other, or have them as one? At what layer should it be at? Michigan's scheme is not a bad one, but California may be different due to the sheer volume of real estate transactions that are subject to withholding in California. FTB staff may want to think about whether to tie them together or not tie them together.

Response: Form 593 is different and probably outside the intended scope of this regulation, but FTB staff will look into this.

- Michigan's deferred deadline is a good idea except that it does not address the issue of the upper tier pass-through entity being unaware of the lower tier pass-through entity's withholding payments made on its behalf until later on. The upper tier pass-through entity may not receive a Form 592-B until July or August and then have to explain why they were unaware of the withholding. Is there a way to more formally address that situation in the regulations?

Response: FTB staff will look into that. The problem is the lower tier pass-through entities are not following the 1/31 deadline, making it difficult to decide where to be flexible.

Discussion: If the lower tier pass-through entity misses a deadline, then there is no sympathy, but a partner has no control.

Response: Is there a possible solution?

Discussion: There is no clear guidance on how to deal with late filed returns. There could be more flexibility in the regulation by waiving penalties and showing it was not the upper tier pass-through entities' fault.

- Why not eliminate withholding on pass-through entities and have the income flow through to the individual.

Response: Yes, that is an alternative approach that we will look into.

- There is a huge issue in those states that require withholding on partners that are pass-through entities where the states cannot trace the payment. Some states have withholding on individuals or corporate partners only, like New York and Pennsylvania.

Response: Does that solve the issue with filing deadlines though? If we have an issue with information moving through multiple tiers, how is only withholding on the upper tier pass-through entity going to solve that problem? If they do not receive information from the lower tier pass-through entity, then there is a monetary penalty for not providing the information; otherwise, the answer would be that they did not receive the information in time.

Discussion: I have clients that do not receive the information, but if they show that they filed within 90 days of receiving the K-1, then penalties can be waived. The reasonable amount of time is inconsistent though. There needs to be a consistent guideline for when it needs to be filed, if they are allowed time.

Response: Yes, we need to be consistent.

- It is easiest to comply when the states do not require pass-through entities to withhold on members or partners that are themselves pass-through entities. Additionally, when states require withholding on distributive share, there is usually only one deadline around the due date of the return, and not a quarterly requirement. Then, it is reconciled with the return at the actual due date of the return. Virginia is an example of a state that does this. Reconciliation can avoid a lot of the tier issues. Some members do not even know what their share is

until the return is done. Withholding throughout the year is then less feasible.

Response: These pass-through entities still have an estimated tax obligation on their partner's share before the K-1's are even available. The pass-through entities already have to estimate the tax throughout the year.

Discussion: They can estimate the withholding, but usually the withholding with nonresidents covers what the liability is. The withholding is still credited because it is paid throughout the year.

- The problem is that the federal pass-through entity return is due at the same time as the personal income tax returns. Until there is a change there, this will continue to be an issue for all states.

Response: Thank you, we will consider all of these comments.

- If considering a quarterly withholding tax regime or quarterly estimate where they do not necessarily have all the information due to tiers, then it may be better if there is a refund mechanism when there is an overpayment, rather than force the refund to be claimed on the personal income tax return, or tier those up the chain. I found this to be more practical.

Response: Are there states that do this?

Discussion: Wisconsin and Connecticut. Wisconsin requires quarterly payments, and then the pass-through entity claims the overpayment at the end of the year for the refund. California allows a refund too for the quarterly. Connecticut does not require quarterly payments though. However, Connecticut allows the pass-through entity to claim the refund if there is an overpayment. It would be better to have a lump sum quarterly, similar to how California does foreign withholding, with annual reconciliation.

- How many levels of withholding will be required? If a pass-through entity is itself a partner in another pass-through entity, will there be withholding at each level? Or only at the lower tier level? If there is a withholding report at the lower tier level, how would that work mechanically with each layer up to the ultimate partner?

Response: Yes, that is the question we are trying to find an answer to, is which scheme to use for these many layers.

Another idea is that some states require withholding or estimated tax payments to be paid on behalf of partners or shareholders who are nonresident individuals or corporations, and not pass-through entities. This is similar to New York and Colorado. Ultimately, this means the lower tier pass-through entity would no longer file a Form 592 to allocate withholding because the withholding obligation would begin with the upper tier pass-through entity, or whichever entity has the ultimate nonresident individual or corporate owner.

A potential issue, however, is that the upper tier pass-through entity still relies on the lower tier pass-through entity to send the income information to the upper tier pass-through entity before it can timely send withholding payments, as well as timely file the withholding forms. Comments about this approach included the following:

- If the withholding payments are due 4/15 by the upper tier pass-through entity and the upper tier pass-through entity overestimated the amount, then it would be more willing to pay by 4/15 if it knew it could receive a refund at the pass-through entity level rather than having to pass it through to the partners. The upper tier pass-through entity may be more willing to rely on an estimate from the lower tier pass-through entity. This is the Wisconsin and Connecticut scheme.
- As a practical consideration, clients do not want to make withholding payments throughout the year because information changes, and so the estimates are not accurate. Although there is a risk of penalty, they would rather pay the penalty than have a tax that they cannot receive a refund for.

Response: It seems the issue is whether the withholding agent can receive the refund for overpayment. Is paying during the year a problem, or the fact that they cannot receive the refund?

Discussion: It is the latter, the difficulty in getting it back. Technically can get it back in California currently, but it is a difficult process.

A final issue with Form 592 appears to be that, if the reported withholding amounts are not exact, then the ultimate individual owner will be denied the withholding credit he or she claimed on their personal income tax return, with an amended Form 592 as the only remedy. Comments included the following:

- An obvious concern when working with the returns is that the ultimate taxpayer has trouble figuring out the right amount to match from the lower tier pass-through entity. Difficult to have the lower level amend the Form 592. If there is a small percentage owner of a pass-through entity, who knows when and if the lower tier pass-through entity will ever amend it. An easy answer is to not require withholding on distributive share of withholding, but withhold on distributions, because then it would be much easier to trace the cash. Has there been a determination of what money is involved with switching to withholding on distributive share? What is the difference? Or, is the goal to make sure all bodies are reporting income? The FTB wants to be sure and find people and collect tax as needed. What is the goal of FTB by changing to requiring withholding on distributive share of income from withholding on actual distributions? Is it for tax collection or keeping tabs on people?

Response: The withholding schemes are based primarily on enforcement issues. The problem with the distribution scheme is with the mechanics of Subchapter K and how you determine whether a distribution is taxable income or not. In many cases, once the distributive share flows through and you distribute cash that is less than that, you have no income to withhold on. Distributive share makes more sense because you are filing K-1's every year anyways and making allocations to the partners that are consistent with that. These are the policy reasons driving this. FTB has not performed a revenue estimate; it is more a cash flow estimate. Unsure what it would yield. The revenue is not what is driving this. It is simpler to tie withholding to an income measure at the end of the day. Other states are doing this as well, presumably for the same reason.

3. Other State Withholding Schemes Relating To Pass-Through Entities:

Any other positives and negatives from other state withholding schemes relating to pass-through entities.

Discussion: None.

4. Withholding Payments On An Annual versus Quarterly Basis:

Another issue is whether withholding payments should be due on a quarterly or annual basis. The states appear to be split down the middle, with half

requiring withholding payments on a quarterly basis and the other half requiring withholding payments on an annual basis. Currently, California requires withholding payments on a quarterly basis. One option could be to continue requiring withholding payments on a quarterly basis. Or, California could require the entire withholding payment on an annual basis on or before the due date of the pass-through entity's return. An issue with this, however, could be that the ultimate owner may be claiming the withholding credit on his or her individual income tax return before the pass-through entity has even paid the withholding, resulting in denial of the withholding credit. Comments included the following:

- Annual withholding is preferred because then there is a better estimate of taxes for the year. The refund could be incorporated if wait to the year end for the due date.

Response: How do states integrate this with the estimated tax scheme to deal with these issues? If a pass-through entity's withholding is insufficient and the individual partner files a return using estimated tax, then how do states use the annual approach on 4/15?

Discussion: It is not as big of a problem for individuals because they can have the overpayments refunded. Then, if they do not know the exact amount of withholding to estimate, then they can overpay before the due date of their return, because they know they receive the refund on their return.

Response: What if it cuts the other way, where the individual points the finger at the pass-through entity and FTB is asked to waive penalties perhaps when it is not appropriate.

- Wage withholding is treated as paid ratably through the year. If the pass-through entity paid once at year end, then treated as paid throughout the year.

Response: It solves the problem if the pass-through entity is paying enough. If the withholding is underpaid, then who should any penalties attributable to such under-withholding fall on? The withholding agent? The investor? What should FTB be doing? The underpayment penalty is mechanical and is essentially strict liability with a reasonable cause exception.

Discussion: Treat the payment as paid ratably by the pass-through entity by 4/15. That would benefit the individual.

Response: Pursue the pass-through entity for the underpayment penalty?

Discussion: It would depend on type of withholding. Individuals could have their own penalty.

Discussion: If the payment is not due until 4/15, then the pass-through entity has a much better shot at being accurate.

- The ultimate owner will blame the pass-through entity and claim he or she is innocent, resulting in lots of reasonable cause requests.

Response: Are there any other states that wrestle with this annual payment scheme versus estimate tax?

Discussion: Connecticut uses the annual payment scheme and they penalize the pass-through entity.

- III. **Closing:** FTB staff intends to consider all comments received today and through January 30, 2015, in meeting with internal staff and recommending a withholding scheme for California to adopt for pass-through entities. Staff will schedule a second interested parties meeting sometime in 2015 that will be conceptual in nature to discuss which scheme California intends to adopt and how it will work. Additionally, it will address the compliance and other issues we have discussed today. This next interested parties meeting will likely be conducted using PowerPoint slides to illustrate how it will be intended to work, rather than having proposed regulation language. Thank you everyone for attending today.