

Request for Permission to Proceed with the Formal Regulatory Process to Adopt Proposed California Code of Regulations, Title 18, Section 18662-7, Addressing Domestic Pass-Through Entity Withholding, and to Adopt Proposed Amendments to California Code of Regulations, Title 18, Sections 18662-0 Through 18662-6 and 18662-8, Addressing Withholding, Generally.

Background

At the September 9, 2021 Franchise Tax Board (FTB) meeting, in open session, FTB staff obtained permission from the FTB to proceed with the formal Administrative Procedures Act (APA) regulatory process to adopt California Code of Regulations, Title 18 (18 CCR), section 18662-7 (Proposed Regulation) and to amend 18 CCR sections 18662-0 through 18662-6, and section 18662-8 (Regulations).

FTB staff submitted a "Request for Permission to Proceed with the Formal Regulatory Process" (Initial Request for Permission) for the September 9, 2021 FTB meeting, which detailed prior interested parties meetings (IPMs) and notices, as well as provided a background summary and explanation of the Proposed Regulation and proposed amendments to the Regulations. This information, shared by FTB staff, noted that the Proposed Regulation would provide guidance with respect to California's domestic pass-through entity withholding, and that the proposed amendments to the Regulations would include language from the Proposed Regulation relating to domestic pass-through entity withholding to ensure consistency across all of the withholding regulations, among other minor changes.

After obtaining permission to proceed with the formal APA regulatory process to adopt the Proposed Regulation and amend the Regulations, FTB staff determined additional revisions to the draft regulatory text were necessary to account for four newly discovered issues. On December 30, 2022, FTB staff posted a 30-day notice to describe the additional necessary revisions and to elicit comments on the proposed revisions to the draft regulatory text, with a deadline of 5:00 p.m. January 31, 2023. The 30-day notice and proposed revisions to the draft regulatory text were posted online on the FTB's website at the [Regulatory Activity](#) page.

FTB staff determined that no further substantive edits to the draft regulatory text were necessary after the close of the 30-day notice comment period.¹

FTB staff is now presenting the FTB with the draft regulatory text, including the revisions as proposed in the 30-day notice, to again request permission to proceed with the formal APA regulatory process to adopt the Proposed Regulation and to amend the

¹ Staff made several non-substantive and grammatical changes discovered after the expiration of the 30-day notice period, including the deletion of redundant language and changes made for purposes of consistency within the regulatory text.

Regulations.² The Initial Request for Permission and 30-day Notice are described more fully below.

Initial Request for Permission

The Initial Request for Permission set forth the ultimate goal of the regulation project - to facilitate fair and efficient tax compliance and administration by requiring domestic pass-through entity withholding agents to remit a portion of a nonresident owner's distributive share of the pass-through entity's California source income directly to FTB which reflects an amount that reasonably represents the amount of tax owed by a nonresident owner of a pass-through entity.

The Initial Request for Permission explained that California Revenue and Taxation Code (RTC) Section 18662 contains the general withholding requirements and the corresponding Regulations provide specific guidance with respect to California's nonresident and real estate withholding procedures, with the most recent amendments becoming effective on October 8, 2019 pursuant to Government Code section 11343.4, subdivision (b)(3)(Register 2019, No. 41).

Next, the Initial Request for Permission summarily described the main issues the regulation project seeks to mitigate. The Regulations generally require a pass-through entity to withhold tax on distributions of California source income paid in the tax year to a nonresident owner at a flat 7 percent tax rate and to file a withholding form on an annual basis. However, a nonresident owner of a pass-through entity is taxed on their distributive share of the pass-through entity's California source income, whether or not distributions are paid, and the majority of states and the IRS foreign partner withholding requirements under IRC 1446 require withholding of tax on distributive share at the highest marginal tax rate. Additionally, an upper tier pass-through entity that has had tax withheld is often required to file the withholding form before it may receive the withholding information necessary to complete the withholding form, often resulting in a late-filed withholding form and the imposition of an information return penalty on the upper tier pass-through entity.

The Initial Request for Permission also provided that the Proposed Regulation would mitigate these issues by requiring a pass-through entity to withhold tax on a nonresident owner's distributive share of the pass-through entity's California source income at the highest marginal tax rate, which would reasonably represent the amount of tax owed and would more closely reflect the withholding requirements of the majority of states and federal language for withholding on foreign partners. Additionally, the Proposed Regulation would mitigate the imposition of information return penalties for the late filing of withholding forms by providing an upper tier pass-through entity with a safe harbor from the imposition of an information return penalty when it certifies that it is filing the withholding form within 30 days of receiving the withholding information from the lower tier pass-through entity.

² See attached draft regulatory text.

Finally, with respect to the proposed amendments to the Regulations, the Initial Request for Permission explained that the proposed amendments would provide consistency with the Proposed Regulation, revise the regulatory language to more closely reflect federal language for withholding on foreign partners, and clarify withholding rules relating to trusts and estates.

30-Day Notice

The 30-day notice summarily described the additional revisions FTB staff determined were necessary to the draft regulatory text and included a description of four main issues FTB staff discovered with the text. The 30-day notice also explained how the proposed revisions were designed to mitigate each issue, as explained below.

The first issue was that the previous draft regulatory text treated a simple trust as a pass-through entity under the Proposed Regulation, which resulted in differing withholding requirements and the filing of different withholding forms with differing due dates between simple trusts under the Proposed Regulation and complex trusts and estates under the Regulations. Therefore, FTB staff proposed revisions to the draft regulatory text to remove simple trusts from previously proposed pass-through entity treatment to ensure all trusts and estates continue to follow the current and same withholding requirements and file the same withholding form, thereby decreasing potential for confusion.

The second issue was that the previous draft regulatory text of the Proposed Regulation mitigated issues arising from the imposition of information return penalties for the late filing of a Form 592-PTE (due on an annual basis with a self-certification safe harbor) in tiered pass-through entity structures, yet the previous draft regulatory text for the proposed amendments to the Regulations did not mitigate the potential issue arising from the imposition of information return penalties for the late filing of a Form 592 (due on a quarterly basis without a self-certification safe harbor) if a non-California trust, estate, or pass-through entity was withheld upon pursuant to the Regulations. Therefore, FTB staff proposed revisions to the draft regulatory text to denote that *all* domestic non-real estate withholding paid or to be allocated, including domestic pass-through entity withholding, be reported on a single form, Form 592, filed on an annual basis, which would have a self-certification safe harbor available.

The third issue was that the previous draft regulatory text provided filing, notification requirements, credit for tax withheld requirements, as well as availability to the self-certification safe harbor to an upper tier pass-through entity that has had tax withheld pursuant to the Proposed Regulation, yet the previous draft regulatory text for the proposed amendments to the Regulations did not provide such clarifying language for a non-California trust or estate that has had income or payments withheld upon, either as a nonresident owner pursuant to the Proposed Regulation or as a non-California trust or estate pursuant to the Regulations. Additionally, there was no such clarifying language for a non-California pass-through entity that has payments withheld upon pursuant to the Regulations. Finally, there was no language specifying that such provisions applying to a non-California trust or estate are dependent on the non-California trust or estate

paying a distribution of that income or receiving a payment that had tax withheld upon. Therefore, FTB staff proposed the addition of language clarifying that a non-California trust or estate that has tax withheld and has paid a distribution of that income or payment received that had tax withheld, or a non-California pass-through entity that has had tax withheld pursuant to the Regulations, will have the same filing, notification, and credit for tax withheld requirements, as well as availability to the self-certification safe harbor as an upper tier pass-through entity that has had tax withheld pursuant to the Proposed Regulation.

The fourth and final issue was that the previous draft regulatory text of the Proposed Regulation provided detailed requirements for when a pass-through entity is required to withhold tax on a nonresident owner, and provided that the term "nonresident owner" includes a non-California trust or estate or upper tier pass-through entity, yet there was no clarification in the proposed amendments to the Regulations relating to whether withholding of tax would continue to be required on payments or distributions made to a non-California trust or estate or pass-through entity that is not a nonresident owner pursuant to the Proposed Regulation, or is a nonresident owner of a pass-through entity pursuant to the Proposed Regulation and is receiving payments or distributions other than distributions paid that have not already been withheld upon. Therefore, FTB staff proposed the addition of language clarifying that withholding of tax may still be required in such scenarios.

FTB staff received one comment within the 30-day Notice comment period. An interested party sought clarification of the overall goal of the regulatory project. FTB staff responded directly to the commentor, summarizing the main goals, as were detailed in the Initial Request for Permission. FTB staff determined that the comment did not require further proposed revisions to draft regulatory text.

Request for Permission

FTB staff believes that the Proposed Regulation and proposed amendments to the Regulations provide appropriate criteria and guidance in implementing RTC section 18662, and now requests permission to commence the formal regulatory process under the APA.