

## California: Revised Proposed Withholding Requirements for Domestic Pass-Through Entities - Public Comments Due June 17<sup>th</sup>

### Overview

On March 15, 2019, the California Franchise Tax Board ("FTB") published amendments to proposed regulation ("Amended Proposed Regulations Draft Language") under California Code of Regulations, Title 18, ("CCR") Section 18662-7, relating to the withholding requirements for domestic pass-through entities, and solicited written comments from the public regarding the amended draft.<sup>1</sup> The FTB issued the original draft proposed regulation in August 2017.<sup>2</sup>

Per the FTB Ninety-Day Notice of Proposed Amendments ("FTB 90 Day Notice"), the FTB will accept written comments until 5 p.m. on June 17, 2019.<sup>3</sup> Currently, the FTB does not anticipate holding an Interested Parties Meeting ("IPM") on these March revisions.<sup>4</sup> Assuming no significant comments or concerns are received during the comment period, the FTB staff intends to present the Amended Proposed Regulation Draft Language to the 3-member board of the FTB to request permission to continue with the formal Administrative Procedures Act (APA) regulatory process.

This Tax Alert summarizes notable changes to Proposed Regulation Section 18662-7 and discusses certain taxpayer considerations.

### Background

Generally, Proposed Regulation Section 18662-7 requires a "pass-through entity" to withhold tax on behalf of a "nonresident owner" in an amount equal to that owner's "tax rate of withholding" multiplied by that owner's distributive share of the pass-through entity's California source income.<sup>5</sup>

In the FTB's 90 Day Notice, the FTB stated that the main revisions to the proposed Draft Language of Proposed Regulation Section 18662-7 were to:

- Provide the option of self-certification to act as a safe harbor for an upper tier pass-through entity that receives a late Form 592-B from its lower tier pass-through entity.
- Eliminate the 10-day notification requirement to avoid the imposition of additional administrative burdens on pass-through entities.
- Provide clarification of previously proposed subsections.<sup>6</sup>

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<sup>1</sup> The draft of the proposed regulatory language is available [here](#). The FTB's Ninety-Day Notice is available [here](#) and the FTB's Discussion of Amendments is available [here](#). By way of background, the FTB first held an Interested Parties Meeting ("IPM") on December 12, 2014 to solicit input from the public on withholding for domestic pass-through entities. A summary of this IPM is available [here](#). The FTB subsequently published draft regulations and held a second IPM on September 8, 2017. The FTB's Meeting Notice and Information for the September 8, 2017 IPM is available [here](#) and the Summary of Second Interested Parties Meeting is available [here](#). The FTB's Explanation Document for the Draft Language is available [here](#) and related diagrams are available [here](#). For further discussion of the initial draft language, please see our prior Tax Alert dated Aug. 31, 2017, available [here](#).

<sup>2</sup> For additional detail, see [External Multistate California FTB proposes new withholding regulation for pass-through entities](#), August 31, 2017.

<sup>3</sup> FTB 90 Day Notice, p.1.

<sup>4</sup> *Id.*

<sup>5</sup> See Cal. Code Regs. tit. 18, sec. 18662-7(a) (proposed amended Mar. 2019). "Distributive share of income" is "computed under Chapter 9 through 11 of part 10 of the Revenue and Taxation Code [{"CRTC"}]; and Chapters 4.5 and 17 of Part 11 of the CRTC." Cal. Code of Regs., tit. 18, sec. 18662-7(b)(1) (proposed amended Mar. 2019).

<sup>6</sup> FTB 90 Day Notice, pp.1-2.

### The Self-Certification Safe Harbor

Amended Proposed Regulations Draft Language adds self-certification as a safe harbor in response to public requests at the IPMs to “reduce the cascading of late filing penalties in tiered structures.”<sup>7</sup> Under the safe harbor,<sup>8</sup> if an upper tier pass-through entity receives a Form 592-B after the January 31<sup>st</sup> due date of its own Form 592-PTE,<sup>9</sup> the FTB will not impose a late filing penalty on the upper tier pass-through entity if that upper tier pass-through entity certifies that it is filing the Form 592-PTE within 30 days of receiving the Form 592-B. However, the upper tier pass-through entity will only avoid this late filing penalty if it files the Form 592-PTE within 30 days of receiving the Form 592-B, and the self-certification is not “fraudulent or otherwise factually incorrect.”<sup>10</sup> To illustrate self-certification, the FTB has added Example 4 to the amended Draft Language of Proposed Regulation Section 18662-7.<sup>11</sup>

### Elimination of 10-Day Notification Requirement

In the FTB’s Explanation Document for the initial Draft Language, the FTB stated that the 10-day notification requirement was imposed to provide “upper tier pass-through entities more time to receive withholding information from the lower tier pass-through entity to timely file Form 592-PTE,” which would ensure “that withholding credit will be timely allocated when the ultimate owners file their income or franchise tax returns to claim the withholding credit.”<sup>12</sup> However, in response to public comments, the FTB eliminated the 10-day notification requirement after concluding that as written it did not provide timely information in tiered partnership structures, stating that its elimination would avoid the imposition of “additional administrative burdens on pass-through entities.”<sup>13</sup>

### Clarification of Previously Proposed Subsections

In addition to the changes described above, the FTB made other revisions to Proposed Regulation Section 18662-7 to clarify certain withholding requirements applicable to domestic pass-through entities. Some of these changes are discussed below.

Withholding Tax Rate – The Amended Proposed Regulations Draft Language specifically provides that the tax rate applicable to each nonresident individual’s distributive share includes the 1% mental health services tax rate and the additional tax rates imposed by Proposition 30. As a result, the maximum tax rate for individuals is 13.3%.<sup>14</sup> Additionally, the draft Proposed Regulation states that the tax rate on pass-through owners which are S corporations includes the 1.5% S corporation entity level tax as well as the highest rate of tax applicable to the individual shareholders of the S corporation. Thus, the combined maximum tax rate for S corporation owners is 14.8%.<sup>15</sup>

Calculation of Income from California Sources Subject to Withholding – The Amended Proposed Regulations Draft Language clarifies the treatment of certain deductions that are subject to limitation at the partner level, for example, investment interest expense and charitable contributions. The draft now contains the language, “The amount subject to withholding by a pass-through entity is calculated based upon the pass-through entity’s California source income and as reported on California Schedule K-1, disregarding any limitations on those items that may apply at the partner’s level.”<sup>16</sup> Based on this language, the full amount of the item reported to the partner may be taken into account in the pass-through entity’s withholding computation, regardless of the fact the item may be limited at the partner level.

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<sup>7</sup> FTB Discussion of Amendments to Proposed Adoption of Regulation 18662-7, p. 12.

<sup>8</sup> See Cal. Code Regs. tit. 18, sec. 18662-7(d)(1)(B)(d) (proposed amended Mar. 2019).

<sup>9</sup> Form 592-PTE is filed on an annual basis by a pass-through entity that is allocating withholding payments to its owners.

<sup>10</sup> See Cal. Code Regs. tit. 18, sec. 18662-7(d)(1)(B)(d) (proposed amended Mar. 2019).

<sup>11</sup> See Cal. Code Regs. tit. 18, sec. 18662-7(h) (proposed amended Mar. 2019).

<sup>12</sup> FTB’s Explanation Document, p.12.

<sup>13</sup> FTB 90 Day Notice, p.1.

<sup>14</sup> In November 2012, California voters approved Proposition 30, which increased the personal income tax rates for individuals with taxable income over \$250,000. Generally, under Proposition 30, the highest tax rate is 12.3 percent. When the 1% mental health services tax is considered the total maximum tax rate for individuals is 13.3%. Please see our prior Tax Alert (Aug. 31, 2017, available [here](#))).

<sup>15</sup> 14.8% consists of the 13.3% maximum tax rate for individual shareholders of the S corporation, plus the 1.5% S corporation entity level tax.

<sup>16</sup> See Cal. Code Regs. tit. 18, sec. 18662-7(b)(2) (proposed amended Mar. 2019).

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**Penalties** – Although not imposing new penalties for failure to withhold taxes or failure to timely provide withholding tax forms to pass-through owners or the FTB, the draft regulation specifically references which existing penalties apply to these situations.

### Unaltered Provisions

The following provisions from the initial Draft Language, discussed in our August 31, 2017 Tax Alert have not changed:

- Withholding on a pass-through entity owner's distributive share of California source income (instead of distributions paid),
- A withholding rate that varies depending on whether the pass-through entity owner is an individual, C corporation, S corporation, or other upper tier pass-through entity (instead of the flat 7% rate), and
- Two new forms—Form 592-Q (filed when a withholding payment is made to the FTB on behalf of a nonresident owner), and Form 592-PTE (filed on an annual basis by a pass-through entity that is allocating withholding payments to its owners).

### Considerations

Taxpayers with domestic pass-through entity structures should consult their tax practitioners to evaluate how the FTB's amendments to the Draft Language of Proposed Regulation Section 18662-7 may impact their businesses as well as to determine whether they should submit written comments to the FTB. The FTB must receive any comments by 5 p.m. on June 17, 2019.

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