

# California FTB proposes new withholding regulation for pass-through entities

## Overview

On September 8, 2017 the California Franchise Tax Board (“FTB”) is holding an Interested Parties Meeting (“IPM”) to discuss recently issued proposed language for a new regulation - California Code of Regulations, title 18 (“Regulation”), Section 18662-7 – that, if adopted, would change the withholding requirements for domestic pass-through entities.<sup>1</sup> Notable changes that would result from this proposed regulation include:

- 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 seven percent rate),
- A ten-day notification requirement for reporting withholding payments to owners, 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).

It should be noted that, as required under current law, upper-tier pass-through entities still must allocate withholding paid by a lower-tier pass-through entity to every owner of the upper-tier pass-through entity (including California residents) and cannot claim a refund of any excess withholding.

This Tax Alert summarizes proposed Regulation Section 18662-7 and provides some taxpayer considerations.

## General requirement for pass-through entity to withhold

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>2</sup> Although the current language does not explicitly state that this withholding is made in lieu of the current requirement to withhold on distributions paid, the FTB has stated that “[p]ass-through entities will be required to withhold on behalf of a nonresident owner’s distributive share of the pass-through entity’s California source income rather than withhold on distributions paid.”<sup>3</sup>

A “pass-through entity” is defined to include “a partnership (as defined by [CRTC Section] 17008 and Regulation section 18662-2(o)), estate or trust, and S corporation.”<sup>4</sup> A “partnership” is defined under those sections to include limited liability companies taxed as partnerships, limited partnerships, and limited liability partnerships.<sup>5</sup>

A “nonresident owner” is defined to include “partners, members, and shareholders that are nonresidents of California, in addition to beneficiaries of an estate or trust that are nonresidents of California” and includes “owners that are nonresident individuals and owners that are non-California business entities, including, but not limited to, such entities as pass-through

<sup>1</sup> A draft of the proposed regulatory language is available [here](#). The FTB’s Meeting Notice and Information for the September 8, 2017 IPM is available [here](#). The FTB’s Explanation Document for the draft language is available [here](#) and related diagrams are available [here](#).

<sup>2</sup> Cal. Code of Regs., tit. 18, § 18662-7(a) (proposed Aug. 2017). “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, § 18662-7(b)(1) (proposed Aug. 2017).

<sup>3</sup> FTB’s Explanation Document, p.1-2.

<sup>4</sup> Cal. Code of Regs., tit. 18, § 18662-7(b)(5) (proposed Aug. 2017). CRTC Section 17008 and Regulation Section 18662-2(o) define “partnership” to mean “a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not a trust, estate, or corporation.”

<sup>5</sup> See Cal. Rev. & Tax Code § 17008; Cal. Code of Regs., tit. 18, § 18662-2(o).

entities, publicly traded partnerships, master limited partnerships, estates or trusts, and suspended or forfeited corporations.”<sup>6</sup> The FTB has explained that the “definition of nonresident owner is intentionally broad and includes individuals, corporations, and all other non-California business entities, as defined in [Regulation S]ection 18662-2(j).”<sup>7</sup>

The “tax rate of withholding” that applies depends on whether the nonresident owner is an individual, C corporation, S corporation, or an upper-tier pass-through entity other than an S corporation.<sup>8</sup> If the nonresident owner is an individual, the rate is the highest marginal tax rate in effect under CRTS Section 17041, which appears to be 13.3 percent<sup>9</sup> (12.3% highest tax rate under Proposition 30<sup>10</sup> and increased 1% for the mental health service tax that is treated as imposed under CRTS Section 17041.)<sup>11</sup> For regular C corporations, the rate is 8.84 percent.<sup>12</sup> For bank and financial corporations, the rate is 10.84 percent.<sup>13</sup> For regular S corporations, the rate is the highest marginal tax rate for individuals plus 1.5 percent (3.5 percent for an S corporation that is a financial corporation).<sup>14</sup> Where the pass-through entity owner is itself a non-California upper-tier pass-through entity, other than an S corporation, the tax rate is the highest marginal tax rate for individuals under CRTS Section 17041.<sup>15</sup>

If this proposed regulation is adopted, any pass-through entity that fails to meet the withholding requirements is subject to penalties under Regulation Section 18662-8(d) and CRTS Sections 18668 and 19183, which includes penalties for failure to file correct information returns and liability for withholding amounts.<sup>16</sup> The FTB has also included examples under subsection (h) of this proposed regulation to illustrate how this regulation should be applied.

### Required payments and reporting of withholdings to the FTB

Reporting withholding payments made for owners. Where withholding must be paid under this proposed regulation, such payment is due by the federal estimated due date as required under Regulation Section 18662-8(c)(1)(B).<sup>17</sup> Although Regulation Section 18662-8(c)(1) does not currently contain a subsection (c)(1)(B), the FTB has explained that this language was intended to reflect “the FTB’s anticipated updates to the Withholding Regulations at [Regulation] section 18662-8(c)(1)(B), requiring withholding payments by the federal estimated due dates.”<sup>18</sup> If a

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<sup>6</sup> Cal. Code of Regs., tit. 18, § 18662-7(b)(4) (proposed Aug. 2017). For the definition of “nonresident individual,” see California Regulation Sections 18662-7(b)(4)(A) (proposed Aug. 2017), 18662-2(d) and (j) (referencing Cal. Rev. & Tax Code § 17014 and Cal. Code of Regs., tit. 18, § 17014), and 18662-4. For the definition of “non-California business entity,” see California Regulation Sections 18662-7(b)(4)(B) (proposed Aug. 2017), 18662-2(b) and (i), and 23038(b)-2 (defining “business entity”).

<sup>7</sup> FTB’s Explanation Document, p.4.

<sup>8</sup> See Cal. Code of Regs., tit. 18, § 18662-7(b)(7) (proposed Aug. 2017).

<sup>9</sup> Cal. Code of Regs., tit. 18, § 18662-7(b)(7)(A) (proposed Aug. 2017).

<sup>10</sup> In November 2012, California voters approved Proposition 30 which, among others, 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.

<sup>11</sup> See Cal. Rev. & Tax Code § 17043(b). The provisions in the proposed regulation dealing with the withholding tax rate for individual nonresident owners appear to be a departure from the current practice of withholding at a rate of 12.3 percent for foreign partners (which excludes the 1% mental health service tax rate). In the FTB’s Explanation Document, the FTB stated that “[i]f the nonresident owner is an individual, then the highest marginal tax rate is the tax rate applied for individuals under [CRTS] Section 17041, including the 1% mental health tax rate, as well as the additional tax rates imposed under Proposition 30.” FTB’s Explanation Document, p.6. This language seems to suggest that the one percent mental health service tax rate is included for purposes of this proposed regulation. Given this language appears contrary to the current practice for foreign partners, it is not entirely clear whether the FTB intended the highest marginal tax rate to include the 1% mental health service tax rate for purposes of this proposed regulation.

<sup>12</sup> Cal. Code of Regs., tit. 18, § 18662-7(b)(7)(B)(i) (proposed Aug. 2017).

<sup>13</sup> *Id.*

<sup>14</sup> Cal. Code of Regs., tit. 18, § 18662-7(b)(7)(B)(ii) (proposed Aug. 2017). This proposed regulation also clarifies that “[t]he tax rate applicable to the distributive share of each resident or nonresident owner of a non-California upper tier S corporation shall consist of the highest marginal tax rate in effect under Revenue and Taxation Code section 17041.” *Id.*

<sup>15</sup> Cal. Code of Regs., tit. 18, § 18662-7(b)(7)(B)(iii) (proposed Aug. 2017). “Pass-through entity owner” includes “partners, members, or S corporation shareholders that own an interest in a pass-through entity, and beneficiaries of an estate or trust. A pass-through entity owner includes individuals and non-California business entities, including, but not limited to, such entities as pass-through entities, publicly traded partnerships, master limited partnerships, estates or trusts, corporations, and suspended or forfeited corporations.” Cal. Code of Regs., tit. 18, § 18662-7(b)(6) (proposed Aug. 2017). An “upper tier pass-through entity” is “an owner of a pass-through entity that is itself a pass-through entity. An upper tier pass-through entity also includes any owner of an upper tier pass-through entity that is itself a pass-through entity.” Cal. Code of Regs., tit. 18, § 18662-7(b)(8) (proposed Aug. 2017).

<sup>16</sup> Cal. Code of Regs., tit. 18, § 18662-7(g) (proposed Aug. 2017); Cal. Code of Regs., tit. 18, § 18662-8(d); Cal. Rev. & Tax Code §§ 18668; 19183.

<sup>17</sup> Cal. Code of Regs., tit. 18, § 18662-7(c) (proposed Aug. 2017); Cal. Code of Regs., tit. 18, § 18662-8(c)(1).

<sup>18</sup> FTB’s Explanation Document, p.7.

pass-through entity is required to withhold and remit payments to the FTB, it must use a new form, Form 592-Q (Payment Voucher for Pass-through Entity Withholding), to make such payment.

Reporting allocation of withholding payments to FTB. In addition to filing Form 592-Q, a lower-tier pass-through entity that makes a withholding payment will also have to file another new form, Form 592-PTE (Pass-Through Entity Annual Withholding Return), under this proposed regulation with the FTB on an annual basis to allocate withholding to each nonresident owner that has income that was withheld upon according to that owner's interest in the lower-tier pass-through entity.<sup>19</sup> Once Form 592-PTE allocates the withholding paid to an upper-tier pass-through entity, the payment is treated as having been paid on behalf of each upper-tier pass-through entity owner.<sup>20</sup>

However, an upper-tier pass-through entity that is only allocating withholding paid on its behalf by a lower-tier pass-through entity will not be required to remit withholding (or file Form 592-Q) on that allocated amount unless it has its own separate withholding requirements (e.g., it has California source income allocable to a nonresident owner that has not already been withheld upon by a lower-tier pass-through entity).<sup>21</sup> Importantly, an upper-tier pass-through entity that is allocating withholding paid by a lower-tier pass-through entity will be required to file a Form 592-PTE with the FTB to allocate withholdings to all of its owners (including California residents).<sup>22</sup>

### Required notification of withholding to nonresident owners

10 day notice period for reporting withholding payments to owners. Under the proposed regulation, a pass-through entity that remits withholding payments to the FTB on behalf of nonresident owners will be required to provide notice to each nonresident owner within ten days of the later of the withholding payment due date or the date such payment was made.<sup>23</sup> Although a specific form is not required, the notification must include the pass-through entity's name, identification number, address, and the owner's name, identification number, address, the owner's distributive share of income, and the amount of tax paid on the owner's behalf.<sup>24</sup>

However, there are three exceptions where a pass-through entity will not be required to comply with this ten-day notification requirement unless the owner requests it. These three exceptions are:

1. The pass-through entity's agent that is responsible for providing notice is the same person that acts as an agent of the owner for purposes of filing the owner's California income tax return for the owner's taxable year that included the withholding payment date,
2. The pass-through entity has at least 500 nonresident owners and the total withholding that the pass-through entity determines that it is required to pay for the tax year on behalf of such owner's distributive share of income is less than \$1,000, or
3. The pass-through entity is an upper-tier pass-through entity that is only allocating withholding paid on its behalf.<sup>25</sup>

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<sup>19</sup> Cal. Code of Regs., tit. 18, § 18662-7(d)(1)(B)(i) (proposed Aug. 2017). Previously, the withholding was allocated to nonresident owners by filing Form 592 by the federal estimate due dates. However, the FTB has stated that the intent for this change was to allow an upper-tier pass-through entity sufficient time to receive withholding information from the lower-tier pass-through entity in order to timely file its Form 592-PTE to properly allocate withholding. FTB's Explanation Document, p.9.

<sup>20</sup> Cal. Code of Regs., tit. 18, § 18662-7(d)(1)(B)(ii)(II) (proposed Aug. 2017).

<sup>21</sup> Cal. Code of Regs., tit. 18, § 18662-7(c), (d)(1)(A), (f) (proposed Aug. 2017).

<sup>22</sup> Cal. Code of Regs., tit. 18, § 18662-7(d)(1)(B)(ii)(I) (proposed Aug. 2017). Proposed Regulation Section 18662-7 does not explicitly address whether withholdings are required on tax-exempt owners of pass-through entities or clarify whether the current rules which do not require withholdings on tax-exempt entities applies would continue to apply. Absent explicit language excluding them from the withholding requirement, withholdings on tax-exempt owners of pass-through entities is presumably required.

<sup>23</sup> Cal. Code of Regs., tit. 18, § 18662-7(d)(2)(B) (proposed Aug. 2017).

<sup>24</sup> *Id.* The FTB has stated that the ten-day notification requirement was imposed "to ensure the upper tier pass-through entity receives withholding information from its lower tier pass-through entity immediately after withholding payments are paid on its behalf. This allows upper tier pass-through entities more time to receive withholding information from the lower tier pass-through entity to timely file Form 592-PTE, and therefore ensures that withholding credit will be timely allocated when the ultimate owners file their income or franchise tax returns to claim the withholding credit." FTB's Explanation Document, p.12.

<sup>25</sup> Cal. Code of Regs., tit. 18, § 18662-7(d)(2)(C) (proposed Aug. 2017). Some uncertainty exists in the language of the Proposed Regulation Section 18662-7 regarding whether the less than \$1,000 withholding threshold is based on the amount paid on behalf of *each* nonresident owner, or the total paid on behalf of *all* nonresident owners.

Reporting allocation of withholding payments to owners. The proposed regulation also requires a pass-through entity that has withheld on income of a nonresident owner or has income that was withheld upon to provide Form 592-B (Resident and Nonresident Withholding Tax Statement) to each owner that is allocated withholding by January 31<sup>st</sup> of the following year, in accordance with Regulation Section 18662-0 through 18662-8 (which contain the existing withholding rules).<sup>26</sup> Any upper-tier pass-through entity that is allocating withholding paid by a lower-tier pass-through entity is required to provide Form 592-B to every owner that will be allocated withholding (including California residents).<sup>27</sup>

### Credits for Tax Withheld

Individuals and Corporations (excluding S corporations): Under the proposed regulation, individuals or corporations (not S corporations) may claim a refund for withholdings paid on their behalf on their own respective California tax returns.<sup>28</sup> A copy of the Form 592-B received from the pass-through entity must be attached to such returns.<sup>29</sup>

Upper-Tier Pass-Through Entities: However, the proposed regulation does not allow an upper-tier pass-through entity generally to claim a refund for withholdings paid on its behalf on its own California tax return, unless the owners of that upper-tier pass-through entity has authorized that entity to use some or all of the withholding credit to satisfy the entity's entity-level tax (consistent with Regulation Section 19002(b) which allows the same).<sup>30</sup> If that upper-tier pass-through entity claims any amount of the withholding on its own return, it must:

1. Attach a copy of the Form 592-B received from the lower-tier pass-through entity as well as a schedule which specifies the amount to be claimed on the upper-tier pass-through entity's tax return and the remaining amount to be allocated to that upper-tier entity's owners, and
2. Attach a schedule to Form 592-PTE that specifies the amount to be claimed on the upper-tier pass-through entity's tax return and the remaining amount to be allocated to its owners.<sup>31</sup>

### Considerations

Proposed Regulation Section 18662-7 changes many of the withholding requirements that would apply to pass-through entities and their owners. However, the current language of this proposed regulation raises several questions as to how these rules should apply and whether and to what extent the current withholding rules found under Regulation Section 18662-0 through 18662-8 would continue to apply in the context of pass-through entities and their owners. For example, proposed Regulation Section 18662-7 does not indicate whether taxpayers can still request waivers from the withholding requirements under Regulation Section 18662-4 (including waivers from withholdings where a limited liability company can show that it paid the nonconsenting nonresident tax for its nonconsenting members), or how the rules should apply to tax-exempt partners.

Moreover, although the apparent intent of a ten-day notification rule was to force lower-tier pass-through entities to immediately report any withholding made on behalf of nonresident owners so that the ultimate owners that are several tiers up the chain can timely receive their withholding allocation in order to claim it on their tax returns, there are no provisions which guarantee that those entities up the chain will in fact immediately notify the next tier. Additionally, there is no requirement that a particular form be used (which suggests that the notification could simply be verbal).

While ambiguities exist in the current proposed language for the new regulation, it should be acknowledged that this is the FTB's first draft of the proposed language. The language may change once comments are received in writing or at the FTB's September 8<sup>th</sup> IPM. Taxpayers should consult their tax practitioners to evaluate how these proposed rules may impact their business as well as whether submitting comments to the FTB regarding the proposed language is advisable.

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<sup>26</sup> Cal. Code of Regs., tit. 18, § 18662-7(d)(2)(A) (proposed Aug. 2017); Cal. Code of Regs., tit. 18, § 18662-8(c)(3)(B); FTB's Explanation Document, p.10.

<sup>27</sup> Cal. Code of Regs., tit. 18, § 18662-7(d)(2)(A) (proposed Aug. 2017); Cal. Code of Regs., tit. 18, § 18662-8(c)(3)(B); *see also supra* n.22 (relating to tax-exempt entities).

<sup>28</sup> Cal. Code of Regs., tit. 18, § 18662-7(e)(1) (proposed Aug. 2017).

<sup>29</sup> *Id.*

<sup>30</sup> Cal. Code of Regs., tit. 18, § 18662-7(e)(2) (proposed Aug. 2017).

<sup>31</sup> *Id.*

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