Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Benoit	Analyst:	Anne Mazur	Bill Number:	AB 2962
Related Bills:	See Legislative History	Telephone:	845-5404	Amended Date:	March 30, 2006
		Attorney:	Patrick Kusiak	Sponsor:	Franchise Tax Board

SUBJECT:	Withholding on California Real Estate Limited to Gain on Sale

SUMMARY

This bill would allow sellers of California real estate to choose between rates of withholding.

SUMMARY OF AMENDMENTS

The March 30, 2006, amendments deleted a provision that would eliminate the amnesty penalty in certain specified situations and added changes relating to the amount that would be required to be withheld upon dispositions of real property. This is the department's first analysis of this bill.

PURPOSE OF THE BILL

The purpose of this FTB-sponsored bill is to help reduce the amount of over-withholding resulting from provisions requiring withholding on real property sales.

EFFECTIVE/OPERATIVE DATE

This bill would be effective and operative for sales occurring on or after January 1, 2007.

POSITION

Support.

On December 1, 2004, the Franchise Tax Board voted 2-0, with the Director of Finance abstaining, to sponsor the language included in this bill.

ANALYSIS

FEDERAL/STATE LAW

Under federal law, 10% of the amount realized on the disposition of a U.S. real property interest must be withheld when a foreign investor disposes of a U.S. real property interest. This withholding obligation is generally imposed on either the buyer or the withholding agent, who must report the amounts withheld and pay them to the IRS.

Board Position:			Department Director	Date
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Prior to 2003, withholding on the sale of California real property applied only to nonresident individuals and certain corporations. AB 2065 (Stats. 2002, Ch. 488) expanded real estate withholding requirements to California residents.

Currently, California law requires, with some limited exceptions, the buyer to withhold 3⅓ % of the total sales price when the buyer is purchasing California real property and the seller is either of the following:

- An individual or a trust, or
- A corporation that has no permanent place of business in California immediately after the sale of the real property.

The exceptions to withholding apply if any of the following conditions are met:

1. The total sales price of the California real property is $100,000 or less.
2. The buyer did not receive written notification of the withholding requirements.[1]
3. A trustee or a beneficiary under a deed of trust is acquiring the property in foreclosure.
4. The seller certifies under penalty of perjury that:
    - The property conveyed was the seller's principal residence,
    - The property is being exchanged under the like-kind exchange provisions of IRC Section 1031,
    - The property was involuntarily converted or sold as defined under IRC Section 1033, or
    - The sale results in a loss to the seller.

The withholding may be modified if income from the property that is sold is taken into account under the installment method of accounting.

THIS BILL

This bill would allow a seller of California real estate to elect an alternative to the current withholding based on 3⅓ % of the sales price. The seller would be able to choose a withholding amount based on the maximum tax rate for individuals or corporations applicable to the gain on the sale. An electing seller would be required to certify the withholding amount in writing under penalty of perjury to the buyer or REEP.

IMPLEMENTATION CONSIDERATIONS

Implementing this proposal would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the normal annual update.

[1] In which case, the real estate escrow person (REEP) is responsible for a failure to notify penalty. A REEP is defined as the person (including but not limited to an attorney, escrow company, or intermediary) responsible for closing the transaction or is the person in control of payment. California law requires the REEP to inform the buyer of the withholding requirements.

The bill language is unclear whether the term “maximum rate” for individuals would be 9.3%, which is the maximum personal income tax rate, or 10.3%, which is 9.3% plus the additional 1% surtax on income over $1 million. For purposes of this analysis, staff assumed the maximum rate would be 9.3%. The current maximum rate for general corporations is 8.84%.

LEGISLATIVE HISTORY

AB 1628 (Klehs, 2005-06), relating to the real estate withholding requirements, would have permitted the failure to withhold penalty to be assessed against a REEP immediately after a failure occurs and to base the imposition of the penalty solely on the REEP’s failure. The bill was vetoed by the Governor because the REEP would be penalized even if the taxpayer ultimately and timely paid the correct tax.

AB 1338 (Chavez, Stats. 2004, Ch. 528) revised and clarified certain provisions of the real estate withholding requirements.

AB 2065 (Oropreza, Stats. 2002, Ch. 488) expanded real estate withholding requirements to California residents.

FISCAL IMPACT

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

ECONOMIC IMPACT

<u>Cash-flow Estimate</u>

This bill would result in cash-flow losses as follows:

Estimated Cash-Flow* Impact of AB 2962 Effective for tax years beginning on or after 1/1/2007 Assumed Enactment after 7/1/2006 in millions			
	2006/07	2007/08	2008/09
Withhold at 3⅓ % of Sales Price or 9.3% on Gains	– $ 45	– $ 5	– $ 5

* Ultimate tax liabilities are not affected, only the timing of payments.

This estimate does not account for changes in employment, personal income, or gross state product that could result from this measure.

<u>Cash-Flow Estimate Discussion</u>

This bill is expected to affect only the timing of payments, not ultimate tax liabilities.

The current 3⅓ % withholding requirement is expected to result in $2 billion in withholding in fiscal year 2005/2006. This withholding is projected to drop by 3% in 2006/2007. Simulations using the department's 2001 and 2002 capital gains samples indicate that allowing taxpayers the 9.3%-of-gains option would reduce the 2006/2007 withholding by 6%, or $116 million. This cash-flow decrease is further reduced by the following factors:

- Adjusted estimated tax payments for current law (40%)
- Adjusted wage withholding for current law (10%)
- No election (10%)

For the first two bullets, it is assumed some taxpayers will have decreased their estimated tax payments or wage withholding to adjust for the real estate withholding at the current rate of 3⅓ % of the sales price. It is further assumed these taxpayers, therefore, would not make the election for the reduced real estate withholding based on gain on sale. For the third bullet, it is assumed that some taxpayers would choose, for other reasons, not to make the election.

The resulting estimated impact for fiscal year 2006/2007 is a cash-flow loss of $45 million. This cash-flow loss would largely be a one-time event. This cash-flow loss would reverse in the subsequent year, but would be offset by a slighter larger cash-flow loss for sales in that year, resulting in a cash-flow loss for 2007/2008 of $5 million. The term "cash-flow loss" means that while ultimate tax liabilities would not be changed, the timing of tax payments through withholding relative to current law by this bill would be impacted.

ARGUMENTS

The withholding rate of 3⅓ % of the sales price was based on the average tax rate of total estimated real property sales affected by the withholding provisions. Because the withholding rate is based on an average, some affected taxpayers are currently being over-withheld. Allowing a taxpayer to choose between a withholding rate based on the sales price or a withholding rate based on the gain would help reduce the amount of over-withholding.

LEGISLATIVE STAFF CONTACT

Anne Mazur
Franchise Tax Board
(916) 845-5404
anne.mazur@ftb.ca.gov

Brian Putler
Franchise Tax Board
(916) 845-6333
brian.putler@ftb.ca.gov