



STANDARDIZED REGULATORY IMPACT ASSESSMENT

Economic Impact Analysis of Domestic Pass-Through
Entity Withholding Proposed Regulation Section
18662-7 and Amendments to Regulation Sections
18662-0 through 18662-6 and 18662-8

Franchise Tax Board

Prepared by the Economic and Statistical Research Bureau

Contents

1.	<i>Introduction</i>	3
2.	<i>Reasons for the Proposed Regulation and Proposed Amendments to the Regulations</i>	5
3.	<i>Major Regulation Determination</i>	7
4.	<i>Public Input</i>	8
5.	<i>Definitions</i>	8
6.	<i>Proposed Regulation and Proposed Amendments to the Regulations</i>	10
7.	<i>California Nonresident Withholding</i>	10
8.	<i>Pass-Through Entities and Schedule K-1</i>	11
9.	<i>Economic Impact Assessment</i>	13
9.1	Number of Impacted Taxpayers	14
9.2	Types of Businesses and Industries Impacted.....	14
9.3	Changes in Tax Revenue	15
9.3.1	Nonresident Withholding Data	15
9.3.2	Adjusted Impact of the Proposed Regulation and Proposed Amendments to the Regulations: Change from PIT Extension Filers	17
9.3.3	Adjusted Impact of the Proposed Regulation and Proposed Amendments to the Regulations: Change from Corp Extension Filers	19
9.3.4	Impact of the Proposed Regulation and Proposed Amendments to the Regulations: Change from Current PIT Nonfilers.....	20
9.3.5	Impact of the Proposed Regulation and Proposed Amendments to the Regulations: Change from Current Corp Nonfilers	21
9.3.6	Net Direct Impact of the Proposed Regulation and Proposed Amendments to the Regulations.....	21
9.4	Dynamic Impact on the State's Economy from Increased State Revenue	22
9.5	Sensitivity Analysis	23
9.6	Administrative Burden on Businesses	25
9.7	Administrative Burden on Owners.....	25
10.	<i>Other Economic Impacts</i>	25
10.1	The Creation or Elimination of Jobs within the State	26
10.2	The Creation of New Businesses or the Elimination of Existing Businesses within the State	26
10.3	The Competitive Advantages or Disadvantages for Businesses Currently Doing Business within the State.....	26

10.4	The Increase or Decrease in Investment in the State.....	27
10.5	The Incentives for Innovation in Products, Materials, or Processes	27
10.6	The Benefits to the Health, Safety, and Welfare of California Residents, Worker Safety, and the State’s Environment and Quality of Life, Among any Other Benefits Identified by the Agency	27
<i>11.</i>	<i>Alternative Regulations</i>	<i>28</i>
11.1	First Alternative: Upper-tier Pass-Through Entity Withholding Requirement	28
11.2	Second Alternative: No Pass-Through Entity Withholding At Any Level.....	29
<i>12.</i>	<i>Additional Cash Flow Impact</i>	<i>30</i>
12.1	The Proposed Regulation and Proposed Amendments to the Regulations Would Not Adversely Impact the California Taxpayer	30
12.2	The Proposed Regulation and Proposed Amendments to The Regulations Do Not Alter Economic Incentives in the Near Term	31
12.3	Impact to the State	31
12.4	Additional Benefits	31

STANDARDIZED REGULATORY IMPACT ANALYSIS

1. Introduction

Withholding is a prepayment of the income tax due on California source income. Employers are required to withhold on all wages of California residents and on wages of nonresidents for services performed in California. The Employment Development Department is responsible for administering the California wage withholding program. The withholding covered by this regulatory action is non-wage withholding.

California Revenue and Taxation Code (R&TC) section 18662 provides the legal basis for non-wage withholding requirements for nonresident and real estate withholding. R&TC section 18662, subdivision (a) provides that the Franchise Tax Board (FTB) may, by regulation, require any person in whatever capacity having the control, receipt, custody, disposal, or payment of items of income, to withhold an amount that reasonably represents the amount of tax due. R&TC section 18662, subdivision (b) lists the items of income from which the FTB may require withholding, and includes partnership income or gains, and other fixed or determinable annual or periodical gains, profits, and income. The corresponding regulations in California Code of Regulations, title 18 (18 CCR), sections 18662-0 through 18662-6 and 18662-8 (Regulations) detail the specific regulations with respect to California's nonresident and real estate withholding procedures. On March 10, 2014, former 18 CCR section 18662-7 was repealed, operative July 1, 2014. (Register 2014, No. 11.) On October 8, 2019, amendments to the Regulations became operative pursuant to Government Code section 11343.4, subdivision (b)(3) (Register 2019, No. 41).

The proposed adoption of 18 CCR section 18662-7 (Proposed Regulation) would provide specific and clear guidance with respect to California's domestic pass-through entity withholding. Currently, a pass-through entity is required to withhold tax on distributions paid to a nonresident owner at a flat 7 percent tax rate. The Proposed Regulation would change the pass-through entity withholding requirement to withhold tax on behalf of a nonresident owner's distributive share of the pass-through entity's California source income at the highest marginal tax rate. The proposed amendments to the Regulations (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 Regulations, among other changes, such as the simplification of withholding forms for domestic non-real estate withholding.

Proposed Regulation

The Proposed Regulation would provide for three major changes to domestic pass-through entity withholding requirements.

First, the Proposed Regulation would change the domestic pass-through entity withholding requirement to more closely align with the language of R&TC section 18662. The Regulations implementing R&TC section 18662 require a pass-through entity to withhold tax on taxable distributions of California source income paid to a nonresident owner. However, a nonresident owner is taxed on their distributive share of a pass-through entity's California source income, whether or not distributions are paid, while a distribution paid to an owner of a pass-through entity is not taxable until the amount distributed exceeds the owner's basis in the pass-through entity. Therefore, California's current requirement for a pass-through entity to withhold tax on taxable distributions paid does not reasonably represent the amount of tax owed by a nonresident owner of a pass-through entity. The Proposed Regulation and the Proposed Amendments to the Regulations would address this 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.

Second, the Proposed Regulation would change the withholding requirements such that a pass-through entity would be required to withhold tax at the nonresident owner's highest marginal tax rate rather than at the current flat 7 percent tax rate. This would increase withholding compliance and encourage the filing of returns to report taxable income. This proposed change would make California's pass-through entity withholding requirements consistent with the withholding regime utilized by a majority of other states and the Internal Revenue Service's (IRS) foreign partner withholding requirements under Internal Revenue Code (IRC) section 1446 (Federal Foreign Partner Withholding).

The current highest marginal tax rate is: 13.3 percent for a nonresident owner of a sole-proprietorship, partnership, or limited liability company; 8.84 percent for a nonfinancial C corporation; 10.84 percent for bank and financial C corporations; 1.5 percent for nonfinancial S corporations; 3.5 percent for bank and financial S corporations; 14.8 percent (13.3 + 1.5) for individual owners of a nonfinancial S corporation; and 16.8 percent (13.3 + 3.5) for individual owners of a financial S corporation

Finally, the Proposed Regulation would mitigate issues arising from the imposition of information return penalties for the late filing of withholding forms (also called information returns) in tiered pass-through entity structures. Currently, an upper tier pass-through entity or non-California trust or estate that has had tax withheld is required to file a withholding form regardless of whether it has received 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. The Proposed Regulation would mitigate this issue by providing a safe harbor to an upper tier pass-through entity or a trust or estate which has tax withheld and is required to allocate the withholding credit to owners or beneficiaries from the imposition of an information return penalty when the upper tier pass-through entity certifies that it is filing the withholding form within thirty days of receiving the withholding information from the lower tier pass-through entity or withholding agent.

Proposed Amendments to the Regulations

The Proposed Amendments to the Regulations would provide consistency with the Proposed Regulation, revise the regulatory language to more closely reflect federal language for Federal Foreign Partner Withholding, and clarify withholding rules relating to trusts and estates, among other changes.

Another change to the Proposed Amendments to the Regulations includes the simplification of withholding forms by consolidating the Form 592-PTE and Form 592 into a single form, Form 592, which would be filed for all domestic non-real estate withholding.¹ Currently, a pass-through entity and trust or estate that withholds tax or was withheld upon is required to file a Form 592-PTE on an annual basis while all other domestic non-real estate withholding is required to be reported on a Form 592 on a quarterly basis. Some taxpayers are confused about filing of these withholding forms, most notably with pass-through entity withholding agents filing a quarterly Form 592 and then a Form 592-PTE after the taxable year. The Proposed Amendments to the Regulations would mitigate this confusion and the filing of redundant withholding forms by requiring one withholding form to be filed after the end of the taxable year for all domestic non-real estate withholding.

This analysis assumes that the Proposed Regulation would become effective January 1, 2025, currently estimated to be the first calendar year after the Proposed Regulation and Proposed Amendments to the Regulations are filed with the Secretary of State.

The economic impact is based, in part, on income and other related growth rate estimates provided by the Department of Finance at the time of the analysis. Because of the inherent uncertainty with any estimate, the FTB has included a sensitivity analysis in Section 17.1.

2. Reasons for the Proposed Regulation and Proposed Amendments to the Regulations

The Proposed Regulation and Proposed Amendments to the Regulations more closely reflect the language of R&TC section 18662 by ensuring withholding amounts reasonably represent the amount of tax owed by a nonresident owner while also aligning California policy more closely with policies in other jurisdictions. Additionally, The Proposed Regulation and Proposed Amendments to the Regulations would mitigate taxpayer concern about information return penalties as well as mitigate taxpayer confusion in filing redundant withholding forms.

Closer Alignment to Language of R&TC section 18662 and Other Jurisdictions.

¹ Real estate withholding would continue to be reported with the filing of a Form 593.

The current regulations implementing R&TC section 18662 require a pass-through entity to withhold tax on distributions of California source income paid to a nonresident owner. However, a nonresident owner is taxed on their distributive share of a pass-through entity's California source income, whether or not distributions are paid, while a distribution paid to an owner of a pass-through entity is not taxable until the amount distributed exceeds the owner's basis in the pass-through entity. Under the current withholding scheme based on distributions paid, the FTB withholds too little from nonresidents. Analysis of over 120,000 tax year 2020 nonresident returns with pass-through income finds that the majority of returns were under-withheld, and that total withholding was about \$2 billion less than total liability. Therefore, California's current requirement for a pass-through entity to withhold tax on distributions paid does not withhold an amount that reasonably represents the amount of tax owed by a nonresident owner of a pass-through entity on their California source income. The Proposed Regulation and Proposed Amendments to the Regulations address this 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.

The current regulations implementing R&TC section 18662 are also not consistent with the language of R&TC section 18662, subdivision (a) and subdivision (b). R&TC section 18662, subdivision (a), provides that the FTB may, by regulation, require any person in whatever capacity having the control, receipt, custody, disposal, or payment of items of income, to withhold an amount that reasonably represents the amount of tax due. R&TC section 18662, subdivision (b) then lists the items of income from which the FTB may require withholding, and includes "...partnership income or gains, and other fixed or determinable annual or periodical gains, profits, and income." FTB is not limited to requiring a withholding agent to withhold on *only* "payment" of items of income, but may instead require a withholding agent to withhold on items of income that it has control, receipt, custody, disposal, or payment of, and the items of income under subdivision (b) include "partnership income or gains...and income." As such, the FTB may require a pass-through entity withholding agent which has the control, receipt, custody, disposal of its own pass-through entity income, including partnership income, to withhold tax on behalf of such income.

The Proposed Regulation and Proposed Amendments to the Regulations rectify the under-withholding and inconsistency with R&TC section 18662. The requirement for a pass-through entity to withhold tax on a nonresident owner's distributive share of the pass-through entity's California source income is also consistent with withholding language in a majority of other states' withholding code sections as well as the IRC for Federal Foreign Partner Withholding. At least 31 states (including California) require nonresident withholding by pass-through entities, and 23 of those require withholding based on the owner's distributive share of pass-through entity source income. Thus, the Proposed Regulation and Proposed Amendments to the Regulations align California more closely with the treatment of this income in other jurisdictions. In particular, the laws in Idaho, Kentucky, Maine, Minnesota, Oregon, and Wisconsin most closely parallel the Proposed Regulation

and Proposed Amendments to the Regulations, as these states also require withholding at the highest marginal rate.

This analysis assumes that the Proposed Regulation and Proposed Amendments to the Regulations will become effective the January 1st of the first calendar year after they are filed with the Secretary of State.

Mitigation of Taxpayer Confusion and Concerns

An additional benefit of the Proposed Regulation and Proposed Amendments to the Regulations is that they mitigate taxpayer concerns about information return penalties and mitigate taxpayer confusion in filing redundant withholding forms.

The Proposed Regulation and Proposed Amendments to the Regulations mitigate taxpayer concerns about information return penalties. For pass-through entities in tiered structures, the Form 592-PTE is required to be filed by a lower tier pass-through entity and an upper tier pass-through entity by the same due date, yet an upper tier pass-through entity often needs information received from the Form 592-B due to the upper tier pass-through entity by the same due date as the Form 592-PTE. Prior to implementation of the Proposed Regulation and Proposed Amendments to the Regulations, delays in receiving information from lower tier pass-through entities could result in information return penalties imposed on upper tier pass-through entities.

To mitigate this issue raised by taxpayers, the Proposed Regulation and Proposed Amendments to the Regulations provides a self-certification safe harbor to pass-through entities and trusts or estates that have tax withheld and that receive withholding information from their withholding agent after the due date for their information return. The self-certification safe harbor generally provides that an information return penalty would not be imposed on a pass-through entity, or trust or estate, for a late filed Form 592 if the pass-through entity, or trust or estate, certifies under penalty of perjury that the Form 592 is filed within 30 days of receiving a Form 592-B from the lower tier pass-through entity. Additionally, the Proposed Regulation and Proposed Amendments to the Regulations mitigate taxpayer confusion by simplifying withholding forms. As described above, some taxpayers are confused in the filing requirements of these withholding forms, most notably with pass-through entity withholding agents filing a quarterly Form 592 and then a Form 592-PTE after the taxable year. This confusion and filing of unnecessary withholding forms would be mitigated by requiring one withholding form to be filed after the end of the taxable year for all domestic non-real estate withholding.

3. Major Regulation Determination

Senate Bill 617 (Stats. 2011, Ch. 496) establishes regulatory impact assessment standards for major regulations. State agencies must conduct a Standardized Regulatory Impact

Assessment (SRIA) when they estimate that a Proposed Regulation has an economic impact exceeding \$50 million.

Because the economic impact of the Proposed Regulation and Proposed Amendments to the Regulations is estimated to be greater than \$50 million in a 12-month period following the proposed full implementation of the regulation, the Department of Finance has instructed FTB that it is proper to treat this implementing regulation as a major regulation.

4. Public Input

The FTB's process for drafting the Proposed Regulation and Proposed Amendments to the Regulations included two interested party meetings and four notices to solicit additional input from taxpayers.

- December 12, 2014 – The FTB held an interested parties meeting to elicit public input on the Proposed Regulation that would address issues related to domestic pass-through entity withholding.
- September 8, 2017 – The FTB held a second interested parties meeting to discuss Domestic Pass-Through Entity withholding requirements and elicit public input on the proposed draft language of the Proposed Regulation on Withholding on Domestic Pass-Through Entities.
- March 15, 2019 – In-lieu of an interested parties meeting, documents were noticed to elicit written comments by June 17, 2019, on revised proposed draft regulation language.
- June 25, 2020 – In-lieu of an interested parties meeting, documents were noticed to elicit written comments by July 27, 2020, on revised proposed draft regulation language.
- June 8, 2021 – In-lieu of an interested parties meeting, documents were noticed to elicit written comments by July 23, 2021, on revised proposed draft regulation language and the addition of proposed amendments to the withholding regulations.
- December 30, 2022 – In-lieu of an interest parties meeting, documents were noticed to elicit written comments by January 31, 2023, on revised proposed draft regulation language to address several newly discovered issues.

Taxpayers and the public had opportunities to discuss the Proposed Regulation and Proposed Amendments to the Regulations and voice their concerns.

5. Definitions

This section defines several terms used in this SRIA:

Nonresident withholding: A prepayment of tax due on a nonresident's California source income. Pass-through entities generally withhold tax on behalf of their nonresident owners. It is not an additional tax. The nonresident owner would report the withholding paid on their behalf as an estimated payment of tax on their individual income or franchise tax return.

Nonresident Owner: For purposes of domestic pass-through entity withholding, a nonresident owner includes owners that are nonresident individuals and owners that are non-California business entities, including, but not limited to, pass-through entities, publicly traded partnerships, master limited partnerships, corporations, and suspended or forfeited corporations. A nonresident owner also includes non-California complex trusts, grantor trusts, simple trusts, or estates, and partners and shareholders that are nonresidents of California.

Distributive Share of a Pass-Through Entity's California Source Income: A nonresident owner's distributive share of a pass-through entity's California source income is computed under Chapters 10 and 11 of Part 10 of the R&TC; or Chapters 4.5 and 17 of Part 11 of the R&TC. The amount subject to withholding by a pass-through entity is then calculated based upon the pass-through entity's California source income and is reported on California Schedule K-1, disregarding any limitations on those items that may apply at the pass-through entity owner's level.

Pass-Through Entity: A pass-through entity is an entity that passes its income or losses through to its owners instead of paying the related tax at the entity level. For purposes of this regulation project, pass-through entities include: partnerships (as defined by R&TC Section 17008 and 18 CCR Section 18662-2(o)), and S corporations. For purposes of withholding, partnerships include general partnerships, limited partnerships, limited liability partnerships, as well as limited liability companies (LLCs) that are taxed as partnerships for income tax purposes.

Pass-Through Entity Owner: A pass-through entity owner includes partners, members, or S corporation shareholders that own an interest in a pass-through entity. Pass-through entity owners also include individuals or business entities, including, but not limited to, pass-through entities, publicly traded partnerships, master limited partnerships, estates or trusts, corporations, and suspended or forfeited corporations. A pass-through entity owner also includes complex trusts, grantor trusts, simple trusts, or estates.

Tiered Partnership: A structure in which a pass-through entity owns an interest in another pass-through entity. An "upper tier" pass-through entity owns an interest in a "lower tier" partnership with California source income.

Cash-flow: The amount of cash moving to or from an entity to the State of California (for purposes of state budgeting).

12-month period: For purposes of measuring the economic impact of this regulation, changes to cash-flows or tax revenues are measured in a 12-month period after the implementation of the regulation project. For measurement purposes, the implementation date is assumed to be January 1st.

6. Proposed Regulation and Proposed Amendments to the Regulations

Under the Proposed Regulation and Proposed Amendments to the Regulations, withholding on behalf of a nonresident owner of a pass-through entity would be calculated differently. Instead of withholding at the current flat tax rate of 7 percent on distributions paid to nonresident owners of pass-through entities with California source income. Instead withholding would apply to the nonresident owner's distributive share of the pass-through entity's California source income and would be calculated at the highest marginal tax rate for each nonresident owner's entity type. This change would result in withholding requirements similar to those that a majority of other states utilize.

The Proposed Regulation and Proposed Amendments to the Regulation would also require a single form, Form 592, due on an annual basis, to be filed with the FTB for all domestic non-real estate withholding. Currently, Form 592 is filed on a quarterly basis for domestic non-real estate withholding other than domestic pass-through entity withholding. Form 592-V is a voucher filed with each quarterly remittance. Form 592-PTE is filed on an annual basis by each pass-through entity that has withheld on the income of a nonresident owner or had its income withheld upon. Form 592-Q is a voucher filed with each quarterly withholding remittance. The Proposed Regulation and Proposed Amendments to the Regulations delete Form 592-PTE and Form 592-Q and denote all domestic non-real estate withholding to be filed on a single form, Form 592, due on an annual basis, with the Form 592-V voucher. The Proposed Regulation and Proposed Amendments to the Regulations provide a pass-through entity, or trust or estate, that has tax withheld with a safe harbor from the imposition of an information return penalty when it certifies that it is filing the Form 592 within thirty days of receiving the withholding information from the withholding agent.

7. California Nonresident Withholding

For California tax purposes, under R&TC Section 17014, an individual is a nonresident when he or she is outside of California for other than temporary or transitory purposes. A non-California business entity is considered a nonresident owner if it is not a California business entity under 18 CCR Section 18662-4(b)(2). A pass-through entity with California source income is required to withhold on behalf of the following nonresident owners: individuals who are nonresidents of California but have California source income through ownership in a pass-through entity with California source income, corporations not qualified by the California Secretary of State to do business in California, non-California estates and trusts, and partnerships that do not have a permanent place of business in this state.

R&TC Section 18662 and the regulations thereunder provide that the FTB may require any person, acting in whatever capacity, having the control, receipt, custody, disposal, or

payment of items of income, including partnership income or gain, to withhold an amount the FTB determines to reasonably represent the amount of tax due.

Currently, the FTB's requirement that a pass-through entity withhold tax on distributions of California source income paid to a nonresident owner at the 7 percent withholding tax rate results in under-withholding.

The FTB may authorize withholding waivers if the nonresident has California tax returns on file for the two most recent tax years in which the taxpayer had a filing requirement and has no outstanding tax obligations with the FTB.

Withholding is optional for the first \$1,500 in payments made during a calendar year.

8. Pass-Through Entities and Schedule K-1

A pass-through entity is a business entity which utilizes pass-through taxation. Income, losses, credits, and deductions of a pass-through are reported on the owners' income or franchise tax return and are taxed at the owners' income tax rate. S-Corporations, partnerships, and LLCs treated as a partnership for income tax purposes are the most common types of pass-through entities. In the case of partnerships and other pass-through entities taxed as partnerships, each partner, not the pass-through entity, is responsible for reporting and paying taxes on their share of the pass-through entity's taxable income. The pass-through entity provides each partner with a Schedule K-1 tax form reflecting the partner's distributive share of income, and the IRS with an information tax form 1065 or 1120-S reflecting the information on the Schedule K-1.

For an upper tier pass-through entity to accurately file its own withholding form, Form 592-PTE, it must use withholding information from a Form 592-B received from its lower tier pass-through entity. Under the prior regime, upper tier pass-through entities were required to submit a Form 592 on a quarterly basis. Often these reporting deadlines arrived before the upper tier pass-through entity received withholding information from the lower tier pass-through entity via Form 592-B. This resulted in upper tier pass-through entities filing a late Form 592 and the imposition of an information return penalty on a per partner basis.

The amendments to 18 CCR Sections 18662-4 and 18662-8, effective October 8, 2019, created two new forms to be filed with the FTB. Form 592-PTE is filed on an annual basis by each pass-through entity that has withheld tax or had tax withheld on their behalf and is required to allocate withholding to the ultimate individual owner, who can then claim the withholding credit on his or her income or franchise tax return. Form 592-Q is a voucher filed with each quarterly withholding remittance. These changes were put in place to alleviate administrative burdens that upper tier pass-through entities had in filing their own withholding Form 592. The combined changes allowed an upper tier pass-through entity

time to receive withholding information from the lower tier pass-through entity in order to timely file its completed Form 592-PTE to properly allocate withholding.

However, an upper tier pass-through entity, or trust or estate, that has had tax withheld is still required to file the Form 592-PTE on the same date it is to receive the Form 592-B containing the withholding information necessary to complete the Form 592-PTE, often still resulting in a late-filed Form 592-PTE and the imposition of an information return penalty on the upper tier pass-through entity. Additionally, a non-California pass-through entity or a non-California trust or estate may have tax withheld pursuant to 18 CCR sections 18662-0 through 18662-6 or 18662-8 and have no guidance on requirements to allocate withholding paid to owners or beneficiaries. The Proposed Regulation and Proposed Amendments to the Regulations would mitigate this issue by simplifying the withholding filing requirements such that there would be a single form, Form 592, due on an annual basis, and by providing a pass-through entity, or trust or estate, that has had tax withheld, with a safe harbor from the imposition of an information return penalty when it certifies that it is filing the Form 592 within 30 days of receiving the Form 592-B from the withholding agent. The Proposed Regulation serves as a companion to the amendments to 18 CCR Sections 18662-4 and 18662-8, effective October 8, 2019, by providing guidance on who is required to file each form, how the Form 592 allocates withholding paid, as well as penalty relief in certain circumstances.

Based on analysis of multiple years of nonresident withholding penalty assessment data it is estimated that, under the current regulation scheme, there could be approximately 40 information return penalties issued for a total of over \$120,000 in assessments for calendar year 2025.

Under the current nonresident withholding requirements, distributions are required to be reported on income tax returns and Schedule K-1s but may not be taxable unless in excess of the partner's capital account. Withholding is only required if and when the distribution exceeds the partner's capital account. Additionally, a nonresident owner is taxed on their distributive share of a pass-through entity's California source income, whether or not distributions are paid. Generally, the income or expense is passed on to the underlying owner and retains its character (for e.g., ordinary income, a capital gain, or charitable contribution). The distributive share is reported on the partner's/shareholder's/member's Schedule K-1.

For example, a New York partnership reports on a Schedule K-1 an Oregon partner's California distribution based on a sale of a painting in California. The New York partnership selling the painting withholds tax on behalf of the Oregon partner. The Oregon partner may have income from a number of states and decides it is not cost effective to file a California tax return—possibly because their gross income or adjusted gross income from all sources falls below the required filing threshold for California or the costs to file are more than the expected refund amount due from the amount withheld. For the same reasons, a non-

California business entity that does not receive a distribution subject to withholding may not file a California return because their gross income is below the filing requirement threshold, or the costs of filing outweigh any refund they may be due. Those who do not have tax withheld on California source income are less likely to file a return.

Under the Proposed Regulation and Proposed Amendments to the Regulations, the pass-through entity is required to withhold tax on behalf of the nonresident owner based on the nonresident owner's distributive share of California source income, not on unique distribution events, thereby providing for a more reasonable representation of the tax owed by the nonresident owner. This change would likely result in a reduction in the number of nonfilers because increased withholding payments could increase the size of refunds available to some taxpayers.

9. *Economic Impact Assessment*

To assess the economic impact of the Proposed Regulation and Proposed Amendments to the Regulations, the FTB must consider the effect of the cash-flows described in this section, Section 9 and in Sections 10 and 12, for both the taxpayer and the state. This economic impact analysis is based on changes over a 12-month period. Two types of taxpayers would experience impacts over a 12-month period.

- Taxpayers (both Personal Income Tax (PIT) and Corporation (Corp) who file returns by the extended return due date.)

Suppose a partnership engages in a transaction that would trigger nonresident withholding in April 2025 and that the nonresident partner files their 2025 tax return on extension and receives a refund in October 2026. Even though there has been no change in the taxpayer's liability, there would be a net cash inflow to the state in the first 12-month period and a net cash outflow from the state in the subsequent period. Therefore, these cash flows must be considered in the economic analysis.

- Taxpayers (both PIT and Corp) who do not file tax returns.

To the extent that the regulation increases withholding on nonfilers, there would be a transfer of cash from those taxpayers to the state that must be considered in the economic analysis.

Taxpayers who file timely returns would not see a change in taxes due and would not see a change in cash-flow in the 12-month period. In the example above, if the taxpayer had filed their return in March 2026 the refund would be issued within 12 months of the withholding. Since the proposed increase in withholding is subsequently offset by a refund/settle-up within 12 months after the Proposed Regulation and Proposed Amendments to the

Regulations changes go into effect, these taxpayers would not be factored into the impact of this regulation.

For measurement purposes, this analysis assumes that the Proposed Regulation and Proposed Amendments to the Regulations becomes effective January 1, 2025, and assumes the first withholding remittance under the proposal would have a due date of April 15, 2025. For estimating the impact of the Proposed Regulation and Proposed Amendments to the Regulations, this date would be the implementation start point for the first 12-month period. The economic impact of the Proposed Regulation and Proposed Amendments to the Regulations, within a 12-month period following implementation depends on the timing of payments made by pass-through entity withholding agents during the taxable year and claimed as a withholding credit by their nonresident owners following the year in which withholding was remitted. Taxpayers who file on or before the initial tax return due date of April 15 would not be impacted within the 12-month regulation measuring period because any withholding change from April 15 of the prior year would be offset at the time their return is filed. Pass-through entities that historically do not file their return by the initial due date may or may not be affected if they make other prepayments during the year which they may adjust to offset withholding changes. Current nonfilers may or may not have an economic impact in the measuring period. Those which owed no tax and now file by the initial return due date would have no net change in the measurement period. Nonfilers who continue not to file would have an impact because there would be withholding payments collected by the state with no offsetting refunds when a return is filed. And finally, current nonfilers that begin filing but do so on extension may or may not have an impact.

9.1 Number of Impacted Taxpayers

The Proposed Regulation and Proposed Amendments to the Regulations more closely reflect the language of R&TC section 18662 by ensuring withholding amounts reasonably represent the amount of tax owed by a nonresident owner while also aligning California policy more closely with policies in other jurisdictions. Additionally, The Proposed Regulation and Proposed Amendments to the Regulations would mitigate taxpayer concern about information return penalties as well as mitigate taxpayer confusion in filing redundant withholding forms.

The taxpayers affected by this regulation are domestic nonresidents with California source income. While the income would be sourced to this state, the impact of the additional tax burden would be on the nonresident owner of the passthrough entity and any economic impact from the additional withholding would occur in the taxpayer's state of residence, and not in California.

9.2 Types of Businesses and Industries Impacted

The types of industries represented by pass-through entities that filed partnership return Form 565 for tax year 2020 and noted on their return that they had domestic nonresident

members are displayed in Table 1. The majority of pass-through entities that would be impacted by the Proposed Regulation and Proposed Amendments to the Regulations fall in the Real Estate and Rental and Leasing and Finance and Insurance industry sectors which is different from withholding on the sale of real property. Roughly 65 percent of these pass-through entities have 10 or fewer total owners, which includes both resident and nonresident owners.

Table 1. Partnership Counts by NAICS Sector

2-Digit NAICS Code	2020 Partnership Counts	% of Total	Industry Sector
53	62,491	39.3%	Real Estate and Rental and Leasing
52	37,823	23.8%	Finance and Insurance
54	13,626	8.6%	Professional, Scientific, and Technical Services
11	6,907	4.3%	Agriculture, Forestry, Fishing, and Hunting
44,45	6,663	4.2%	Retail Trade
81	5,360	3.4%	Other Services
72	4,466	2.8%	Accommodation and Food Services
23	3,560	2.2%	Construction
62	3,209	2.0%	Health Care and Social Assistance
Other	3,112	2.0%	Misc. other & Others
71	2,572	1.6%	Arts, Entertainment, and Recreation
56	1,967	1.2%	Admin. Support and Waste Management and Remediation Services
55	1,853	1.2%	Management of Companies
42	1,677	1.1%	Wholesale Trade
31,33	1,466	0.9%	Manufacturing
51	1,402	0.9%	Information
21	446	0.3%	Mining
22	160	0.1%	Utilities
49	<u>127</u>	<u>0.1%</u>	Transportation and Warehousing
Total	158,887	100.0%	

9.3 Changes in Tax Revenue

9.3.1 Nonresident Withholding Data

The data for this estimate is based on Schedule K-1s filed with PIT and Corp tax returns in taxable year 2020—the most recent tax year with complete data at the time the analysis was initiated. The first step was to gather tax year 2020 Schedule K-1 data from taxpayers identified as nonresidents who were determined to have California source income.

California received more than 8 million Schedule K-1s for tax year 2020 (for both resident and non-residents). From these forms the FTB identified 248,422 unique PIT nonresident entities, and 19,649 unique Corps with California source income (Table 2).

Next, these entities were classified as either filers or nonfilers. Those who did not file a tax return within the last 3 years despite receiving a Schedule K-1 are classified as nonfilers. For cases where partners filed a group return, data match strategies were supplemented with manual verification to estimate the number of partners that filed the required returns.

Amongst the PIT filers, 218,349 had filed a tax return within the last three years, and 141,499 of them filed a timely tax return, the remaining 76,849 filed on extension. Timely filers are not impacted by the change in the withholding calculation since they settle within the 12-month timely filing period. Of the nonresident Corp filers 16,426 filed in the last 3 years, 4,366 filed timely, and 12,060 filed on extension.

Table 2. 2020 Filing Detail

	PIT Taxpayers	Corp Taxpayers	Total
Nonresident Entities, with California Source Income	248,422	19,649	268,071
Filed a return in the last 3 years	218,349	16,426	234,774
No Return Filed in the last 3 years	<u>30,073</u>	<u>3,223</u>	<u>33,296</u>
	248,422	19,649	268,071
Timely Filers (filed by the initial due date)	141,499	4,366	145,865
Extension Filers	<u>76,849</u>	<u>12,060</u>	<u>88,909</u>
	218,348	16,426	234,774

For the economic impact analysis of the Proposed Regulation, the focus is on nonresident owners of pass-through entities who filed a tax return outside the 12-month period—the 76,849 PIT extension filers, and 12,060 Corp extension filers. Of the PIT extension filers, 58,261 (Table 3) currently make large estimated payments, or extension payments, and excess payments above their tax due is refunded. These taxpayers can address any proposed increase in withholding with adjustments to the large payments they currently make and still have enough to be refunded. The remaining 18,588 PIT extension filers, based on our estimates, would continue to make small prepayments and would be impacted by the increase in withholding.

Amongst the Corp extension filers, 8,450 pay more than the minimum tax and make estimated or extension payments. These taxpayers can adjust current payments to offset the increase in their withholding. The remaining, 3,610 filers make smaller prepayments and would likely be impacted by this regulation. Of the 3,610 who make smaller

prepayments, 2,165 pay the \$800 minimum tax and would not be affected by the increase in withholding because their smaller prepayments are more than sufficient to cover their \$800 in tax liability. The remaining 1,455 taxpayers (3,610 – 2,165), who pay more than the minimum tax would be the group most impacted by the new withholding requirement.

Table 3. 2018 Extension Filer Returns

	PIT Taxpayers	Corp Taxpayers	Total
Extension Filer Return Counts	76,849	12,060	88,909
Make Large Estimated/Extension Payments	58,261	8,450	66,711
Make Small Prepayments	<u>18,588</u>	<u>3,610</u>	<u>22,198</u>
	76,849	12,060	88,909
Corp Small Prepayments:			
Min Taxpayers		2,165	
Pay Above Min Tax		<u>1,445</u>	
		3,610	

In taxable year 2020, withholding was \$155.6 million for PIT extension filers and \$263.3 million for Corp extension filers (Table 4) and these taxpayers are expected to be impacted by the proposed regulation. This regulation would have required an additional \$48.9 million from PIT extension filers and \$28.2 million from Corp extension filers in 2020. A key assumption in this estimate is that taxpayers would make adjustments whenever possible to accommodate cost increases and that these adjustments would not adversely affect a business's current level of operations. These adjustments are reflected in Sections 9.3.2 and 9.3.3.

Table 4. 2018 Withholding Payments

	PIT Taxpayers	Corp Taxpayers	Total
Extension Filer Withholding:			
Current Withholding	\$155,645,764	\$263,289,433	\$418,935,198
New Withholding - Proposed 18662-7	<u>\$204,568,113</u>	<u>\$291,504,119</u>	<u>\$496,072,232</u>
Additional Withholding	\$48,922,349	\$28,214,686	\$77,137,035

9.3.2 Adjusted Impact of the Proposed Regulation and Proposed Amendments to the Regulations: Change from PIT Extension Filers

In many cases the increased withholding would be offset by changes in taxpayer behavior. Table 5 and Table 6 present estimates of these offsets for PIT and Corp taxes respectively.

The gross impact of the Proposed Regulation and Proposed Amendments to the Regulation on PIT extension filers, before expected changes in taxpayer behavior, is estimated at \$48.9 million. Currently, a taxpayer with a history of filing California returns may request a withholding waiver (Form 588). A taxpayer may request reduced withholding (Form 589) when the 7 percent withholding (now the highest marginal tax rate) results in significant over-withholding. A domestic nonresident partner or member may claim exemption on a signed exemption form (Form 590-P). Neither an exemption certificate nor a letter waiving withholding eliminates the requirement to file a tax return and pay the tax due. Data from taxable year 2020 on withholding waivers and exemption requests to the FTB show that nearly 50 percent of taxpayers subject to current withholding are granted waivers and/or exemptions. Because the counts for withholding payments and withholding waiver requests are known, but the dollar amount for those exempted is an unknown, this analysis conservatively assumes that 40 percent of PIT extension return filers impacted by the Proposed Regulation changes would apply for and receive withholding exemptions or reduced withholding. This results in the gross impact being reduced to \$29.4 million.

For some taxpayers, the new withholding could generate larger refunds. Taxpayers currently filing on extension would be incentivized by the regulation to file by the initial due date to accelerate the receipt of these refunds. Those that change their behavior in this way would be filing and offsetting their increased withholding within the 12-month period after the implementation of the Proposed Regulation, so they would not generate a net economic impact. This analysis assumes that taxpayers that do not receive a waiver and that have increases in withholding of more than \$3,000 would accelerate their filing date. This results in a 20 percent reduction in the economic impact of the regulation, or an adjustment of \$5.9 million.

Some taxpayers whose withholding would increase are currently making large payments when they file their request for an extension to file. These taxpayers would likely respond to the withholding increase by reducing their April payments. For this group of taxpayers, the reduction in April payments would occur within 12 months of the withholding, so this group should be excluded from the economic impact analysis. The 2020 data indicates that a little over \$3.5 million in increased withholding would be offset in this way.

Table 5. PIT Adjustments

	Reduction	2020 Impact
Increase in Withholding		\$48,922,349
Withholding Exemptions	40.0%	<u>-\$19,568,940</u>
Remaining Extension Filers		\$29,353,409
Taxpayers switching from Extension to Timely Filing	20.0%	<u>-\$5,870,682</u>
Reduce Extension Payments	15.0%	<u>-\$3,522,409</u>
Current Extension Refunds Moving To Timely Filed		<u>-\$5,112,621</u>
Cash Impact on PIT Extension Filers		\$14,847,697

Finally, the increase in withholding would incentivize some taxpayers who are currently receiving refunds but filing for extensions to file timely and accelerate their (now larger) refunds. This would move the refunds that they are currently receiving from outside the 12-month measurement period to inside the 12-month period. The data shows that about \$5.1 million in refunds could fall into this category.

After these adjustments, the resulting net impact for taxable year 2020 PIT extension filers is \$14.8 million. The forecasts were then adjusted for changes in the economy through the first year of the Proposed Regulation and Proposed Amendments to the Regulations' implementation, resulting in an estimated net impact from taxable year 2025 PIT extension filers of about \$22 million.

9.3.3 Adjusted Impact of the Proposed Regulation and Proposed Amendments to the Regulations: Change from Corp Extension Filers

The gross impact of the Proposed Regulation and Proposed Amendments to the Regulations on Corp extension filers is estimated at \$28.2 million. This analysis assumes that, whenever possible, these taxpayers would adjust to minimize the impacts of the increased withholding on their current level of operations (Table 6).

Based on the 2020 withholding waivers and exemption requests data analysis discussed above, it is estimated that 40 percent of Corp extension taxpayers would also file, and receive, either waivers or exemptions from withholding. These waivers would reduce withholding by \$11.3 million, leaving an impact of \$16.9 million.

Data from taxable year 2020 indicates that 50 percent of C-Corp taxpayers filing on extension would be subject to a withholding increase of \$50,000 or more and thus would have incentive to file earlier. Because of the complexity of corporate returns, the assumption was that only a quarter of this incentivized group, estimated to have a \$4.2 million increase in withholding, would change their filing behavior and get their refunds within the 12-month measurement period.

Additionally, many Corp taxpayers make large extension payments and receive refunds to prevent any chance of underpayment and late payment penalties. Analysis of taxable year 2020 return detail from over 1,600 extension filer returns shows that over 60 percent might be able to offset increased withholding by reducing their extension payments. This analysis assumes that half that number, or 30 percent of the remaining extension filers, would do this. This results in another \$3.8 million in increased withholding offsets within the 12-month period and is excluded from this analysis.

As described above, some corporations may react to increased withholding by filing returns on the original due date, accelerating refunds that they currently receive outside of the 12-month period into the regulation measurement impact period. Analysis of 25 percent of the

1,600 C-Corp and S-Corp extension returns that would likely move to timely filing suggests that about \$632,000 in currently received refunds would be accelerated into the 12-month window.

Table 6. Corp Adjustments

	Reduction	2020 Impact
Increase in Withholding		\$28,214,686
Withholding Exemptions	40.0%	-\$11,285,874
Remaining Extension Filers		\$16,928,812
Taxpayers switching from Extension to Timely Filing	25.0%	-\$4,232,203
Reduce Extension Payments	30.0%	-\$3,808,983
Current Extension Refunds Moving To Timely Filed		-\$632,346
Bump up for Financials	5.0%	\$846,441
Cash Impact on Corp Extension Filers		\$9,101,721

The impact for S-Corps and C-Corps was estimated using tax rates of 1.50 percent and 8.84 percent respectively. However, a small share of total income comes from financial industry corporations subject to slightly higher tax and withholding rates. Financial industry returns are difficult to identify in the data. To account for the share of financial returns represented in the estimate, an increase of 5 percent was applied to the overall impact. This is based on the average share of total state net income in the financial industry as a share of all corporations in taxable year 2020. The net overall impact of 18662-7 for Corp extension filers after these adjustments is \$9.1 million. The forecasts were then adjusted for changes in the economy through the first year of the Proposed Regulation and Proposed Amendments to the Regulation's implementation, resulting in an estimated net impact from taxable year 2025 Corp extension filers of \$12.9 million.

9.3.4 Impact of the Proposed Regulation and Proposed Amendments to the Regulations: Change from Current PIT Nonfilers

Analysis of Schedule K-1s reporting California source income suggests that in taxable year 2020 there were almost 30,000 nonresident individuals that would be affected by this regulation project that did not file a California tax return. After the implementation of the Proposed Regulation and Proposed Amendments to the Regulations, it is estimated that over 27,000 of the nonfilers would file and over 3,000 would continue to be nonfilers primarily because they would have income below the California filing requirement and would have very little financial incentive to file. The net increase in tax from new filers would be approximately \$32.8 million. There is also a cash gain to the state of about \$1.4 million due to the 3,000 nonfilers who choose to walk away from withholding payments. The total revenue gain to the state from current PIT nonfilers would, therefore, be about \$34.2 million for taxable year 2020. The forecasts were then adjusted for changes in the economy through the first year of the Proposed Regulation and Proposed Amendments to the

Regulation's implementation, resulting in an estimated net impact for taxable year 2025 PIT nonfilers of \$51.4 million.

9.3.5 Impact of the Proposed Regulation and Proposed Amendments to the Regulations: Change from Current Corp Nonfilers

According to the Audit Division at the FTB, most pass-through entities that have members with large Schedule K-1 income file on behalf of their nonresident owners. There are very few nonfiling out-of-state corporations with California income. Our analysis identified \$24 million of net income for 3,223 Corp nonfilers in taxable year 2020. Applying an average effective tax rate of approximately 4.4 percent (calculated by dividing the income of Corps reporting net income by the tax assessed on these entities) results in an estimated net impact of \$1.1 million in taxable year 2020. The forecasts were then adjusted for changes in the economy through the first year of the Proposed Regulation and Proposed Amendments to the Regulation's implementation, resulting in an estimated net impact from 2025 corporate nonfilers of \$1.6 million.

9.3.6 Net Direct Impact of the Proposed Regulation and Proposed Amendments to the Regulations

The total estimated net cash-flow in taxable year 2025 from Proposed Regulation and Proposed Amendments to the Regulations is the sum of the amounts described in the previous sections (Table 5 and Table 6) for taxable year 2020, grown for changes in the economy through taxable year 2025, or approximately \$88 million. There is an initial one-time bump in 2025 due to the new PIT and Corp filers in 2025. However, because final extension payments for 2025 are made in the same time period as withholding payments for 2026, the net impact on payments for 2026 for taxpayers accelerating final extension payments into withholding payments is the amount accelerated from taxable year 2026 final payments into taxable year 2026 withholding, minus the amount accelerated from taxable year 2025 final payments into taxable year 2026 withholding. Recognizing this offset, and adjusting for forecasted growth in the economy, net cash flow is estimated to be about \$88 million in 2025, \$57 million in taxable year 2026, and \$59 million in taxable year 2027 (Table 7).

Table 7. Total Revenue Impact

	2025 Impact	2026 Impact	2027 Impact
Additional Revenue from PIT Extension Filers	\$21,996,868	\$22,878,402	\$23,791,015
Less Accelerated Withholding To Prior Year	=	<u>-\$21,996,868</u>	<u>-\$22,878,402</u>
Net PIT	\$21,996,868	\$881,534	\$912,613
Additional Revenue from CORP Extension Filers	\$12,870,807	\$13,659,525	\$14,247,399
Less Accelerated Withholding To Prior Year	=	<u>-\$12,870,807</u>	<u>-\$13,659,525</u>
Net CORP	\$12,870,807	\$788,718	\$587,874
New PIT Filers (current nonfilers)	\$51,427,483	\$53,488,462	\$55,622,101
New CORP Filers (current nonfilers)	<u>\$1,566,206</u>	<u>\$1,628,973</u>	<u>\$1,693,952</u>
Total Net Impact	\$87,861,364	\$56,787,686	\$58,816,540

9.4 Dynamic Impact on the State’s Economy from Increased State Revenue

The Bureau of Economic Analysis’ Regional Input-Output Modeling System (RIMS II) produces regional multipliers that can be used to determine the economic impact of a project, or change in economic activity, in a particular region. The economic impact estimated by applying RIMS II multipliers to the direct impact of the regulation as estimated above are presented in Table 8. This analysis suggests that the change in overall California economic output would be about 2.12 times the cash-flow generated by the Proposed Regulation and Proposed Amendments to the Regulation's. As described above, the initial increase in cash-flow is estimated to be \$88 million in the first full year of implementation and \$59 million in the third year. The total output generated from this injection would be approximately \$186 million in the first year of implementation and \$125 million in the third year. In terms of its impact on household earnings, this injection into the economy translates to an increase in household earnings of about \$50 million in 2025, declining to about \$34 million in 2027. An increase of this magnitude corresponds to the potential creation of about 800 new part-time and full-time jobs in the year the Proposed Regulation and Proposed Amendments to the Regulations goes into effect. The overall value added to state government enterprises would be approximately \$1.1 for every additional dollar generated, approximately \$95 million in taxable year 2025. Estimates for subsequent years are based on forecasted growth of profits of California nonresident incomes.

Table 1. RIMS II Multipliers: Government Enterprises

Multiplier and Description	2025 Final Demand	2026 Final Demand	2027 Final Demand
Initial Increase in Revenue (Base)	<u>\$87,861,364</u>	<u>\$56,787,686</u>	<u>\$58,816,540</u>
Output Multiplier per \$1 change in Final Demand	2.1224	2.1224	2.1224
Estimated Total Industry Output	<u>\$186,476,958</u>	<u>\$120,526,185</u>	<u>\$124,832,225</u>
Earnings Multiplier per \$1 change in Final Demand	0.5728	0.5728	0.5728
Estimated Total Household Earnings	<u>\$50,326,989</u>	<u>\$32,527,987</u>	<u>\$33,690,114</u>
Employment Multiplier per \$1 Million Change in Final Demand	9.0761	9.0761	9.0761
Estimated Total Jobs Created	<u>797</u>	<u>515</u>	<u>534</u>
Value Added Multiplier per \$1 Change in Final Demand	1.0794	1.0794	1.0794
Estimated Total Value Added	<u>\$94,837,556</u>	<u>\$61,296,629</u>	<u>\$63,486,574</u>

9.5 Sensitivity Analysis

As described above, the impact estimate is based on a number of assumptions on taxpayer responses to the Proposed Regulation and Proposed Amendments to the Regulations, including: the number of taxpayers that would seek waivers from the new withholding requirements, the number of taxpayers that would adjust other tax payments to counteract the new withholding requirements, the number of taxpayers that would accelerate the filing of their taxes, and the number of current nonfilers that would begin filing tax returns. If taxpayer responses are more aggressive than assumed by the analysis, the economic impact would be smaller than estimated above. If taxpayers are less responsive to the Proposed Regulation and Proposed Amendments to the Regulations than assumed by the analysis, then the initial economic impact would be greater. To frame the likely range of the economic impact, Table 9 presents the economic impact of the Proposed Regulation and Proposed Amendments to the Regulations if the initial revenue increase is 20 percent lower than reflected in Table 8. Table 10 presents the economic impact of the Proposed Regulation and Proposed Amendments to the Regulations if the initial revenue increase is 20 percent higher than reflected in Table 8.

The initial increase in cash-flow would range from approximately \$70 million to \$105 million in the first full year of implementation decreasing to \$47 million to \$71 million in the third year, primarily due to the acceleration of final extension payments into withholding payments. The total output generated from this injection would be between \$149 million and \$224 million in the first year of implementation and \$100 million to \$150 million in the third year. In terms of its impact on household earnings, this injection into the economy

translates to an increase in household earnings of between \$40 million and \$60 million in 2025, and \$27 million and \$40 million in 2027. An increase of this magnitude could potentially result in the creation of between 638 and 957 new part-time and full-time jobs in the year the Proposed Regulation and Proposed Amendments to the Regulations goes into effect. The overall value added to state government enterprises would be approximately \$1.1 for every additional dollar generated, that is, between \$76 million and \$114 million in taxable year 2025.

Table 2. Impact at a Lower Bound - 80%

Multiplier and Description	2025 Final Demand	2026 Final Demand	2027 Final Demand
Initial Increase in Revenue (Lower Bound)	<u>\$70,289,091</u>	<u>\$45,430,149</u>	<u>\$47,053,232</u>
Output Multiplier per \$1 change in Final Demand	2.1224	2.1224	2.1224
Estimated Total Industry Output	<u>\$149,181,567</u>	<u>\$96,420,948</u>	<u>\$99,865,780</u>
Earnings Multiplier per \$1 change in Final Demand	0.5728	0.5728	0.5728
Estimated Total Household Earnings	<u>\$40,261,591</u>	<u>\$26,022,389</u>	<u>\$26,952,091</u>
Employment Multiplier per \$1 Million Change in Final Demand	9.0761	9.0761	9.0761
Estimated Jobs Created	<u>638</u>	<u>412</u>	<u>427</u>
Value Added Multiplier per \$1 Change in Final Demand	1.0794	1.0794	1.0794
Estimated Total Value Added	<u>\$75,870,045</u>	<u>\$49,037,303</u>	<u>\$50,789,259</u>

Table 3. Impact at an Upper Bound - 120%

Multiplier and Description	2025 Final Demand	2026 Final Demand	2027 Final Demand
Initial Increase in Revenue (Upper Bound)	<u>\$105,433,636</u>	<u>\$68,145,223</u>	<u>\$70,579,848</u>
Output Multiplier per \$1 change in Final Demand	2.1224	2.1224	2.1224
Estimated Total Industry Output	<u>\$223,772,350</u>	<u>\$144,631,422</u>	<u>\$149,798,670</u>
Earnings Multiplier per \$1 change in Final Demand	0.5728	0.5728	0.5728
Estimated Total Household Earnings	<u>\$60,392,387</u>	<u>\$39,033,584</u>	<u>\$40,428,137</u>
Employment Multiplier per \$1 Million Change in Final Demand	9.0761	9.0761	9.0761
Estimated Jobs Created	<u>957</u>	<u>618</u>	<u>641</u>
Value Added Multiplier per \$1 Change in Final Demand	1.0794	1.0794	1.0794
Estimated Total Value Added	<u>\$113,805,067</u>	<u>\$73,555,954</u>	<u>\$76,183,888</u>

9.6 Administrative Burden on Businesses

The Proposed Regulation and Proposed Amendments to the Regulations would result in four administrative changes for businesses that are pass-through entities with nonresident owners. First, the basis of withholding on nonresident owners is changed to the nonresident owner's distributive share of the pass-through entity's California source business income. Although not currently used for California withholding, businesses that are pass-through entities are already required to calculate distributive share and report the distributive share to each owner so this change should not result in additional administrative costs. Second, the Proposed Regulation and Proposed Amendments to the Regulations change the percentage of income to have tax withheld. This is not expected to result in substantial additional administrative costs.

Third, there would be some pass-through entity nonresident owners who are not currently subject to withholding but would be under the Proposed Regulation and Proposed Amendments to the Regulations. As a result, there would likely be an increase in the number of pass-through entity businesses remitting withholding on behalf of their nonresident owners. This change could result in additional administrative cost related to executing these remittances. The exact number of pass-through entity businesses facing an increased burden is not known precisely. There are approximately 50,000 businesses (Tables 1 and 7) with at least one nonresident partner. If five percent of them switch from not remitting to remitting, about 2,500 businesses would be affected. The FTB estimates initial minor one-time set-up costs of less than \$500 per year, and on-going costs of \$100 to \$150 per business per year to remit, the total increase in annual administrative costs is estimated to be between \$250,000 to \$375,000 per year.

Fourth, the proposed safe harbor for multi-tier pass-through entities, or trusts or estates, that have had tax withheld on their behalf, could reduce the administrative costs for those businesses currently subject to potential penalties that would be removed under the Proposed Regulation and Proposed Amendments to the Regulations.

9.7 Administrative Burden on Owners

It is unclear if there would be a change in the administrative burden for nonresident owners. There may be an increased administrative burden in the range of \$500 to \$800 per return, per year, on nonresident owners who currently do not file California returns but would choose to do so after the adoption of the Proposed Regulation and Proposed Amendments to the Regulations, for the cost of hiring a tax professional to complete a California tax return.

10. Other Economic Impacts

The Proposed Regulation and Proposed Amendments to the Regulations would require withholding based on a nonresident owner's distributive share of the pass-through entity's California source income at the highest marginal tax rate. Since these are not California resident taxpayers, the ability for California businesses to compete with businesses from other states would not be hindered or enhanced. It could increase California tax revenue as those who currently owe taxes, but do not file would be required to file, and withholding would increase. The revenue gain to the state will be allocated as part of the state's budgetary process and would not create a competitive advantage or disadvantage for California businesses.

Government Code Section 11346.3(c) requires the following items to be addressed for major regulations.

10.1 The Creation or Elimination of Jobs within the State

The Proposed Regulation and Proposed Amendments to the Regulations could result in the creation of 638 to 957 part-time and full-time jobs in the state in the first year of implementation. The actual number of new jobs created would depend on the Governor's budgetary priorities. It is expected that no existing jobs would be eliminated as a result of nonresident taxpayers paying taxes on their California source income.

10.2 The Creation of New Businesses or the Elimination of Existing Businesses within the State

The Proposed Regulation and Proposed Amendments to the Regulations would neither create nor eliminate a significant number of businesses in California. The FTB believes the withholding changes may result in offsetting portfolio adjustments between resident and nonresident members with no net change in aggregate investments to California entities. Any increase in state tax revenue due to additional withholding imposed, and taxes paid would impact nonresident taxpayers residing outside this state. As such, any additional revenue would be state budget revenue, subject to the state's budgetary priorities. No existing California businesses are expected to be eliminated.

10.3 The Competitive Advantages or Disadvantages for Businesses Currently Doing Business within the State

The additional withholding required by the Proposed Regulation and Proposed Amendments to the Regulations would only be paid by businesses with nonresident owners, so there would be no direct impacts on California businesses owned by residents. By helping businesses with nonresident owners become more tax compliant, the Proposed Regulation and Proposed Amendments to the Regulations would level the competitive playing field for

in-state businesses and may provide some indirect benefits for California businesses owned by residents. Although the proposed withholding requirement changes for nonresident investors might be perceived as a disadvantage for California business seeking funds, the FTB believes the changes would result in portfolio adjustments between resident and nonresident members and thus no net change in aggregate investments within the state. The increase may have a minor impact on businesses owned by nonresident taxpayers investing in California but would not impact businesses owned by California residents.

10.4 The Increase or Decrease in Investment in the State

The Proposed Regulation and Proposed Amendments to the Regulations would neither increase nor decrease investment in California. The FTB believes any reduced nonresident investment due to perceived increased withholding burden would be offset with portfolio adjustments between resident and nonresident members and thus no net change in aggregate investments. In most other cases the impact of the additional withholding is minor and temporary, and additional new tax collected would be from nonfilers who would now file a tax return.

10.5 The Incentives for Innovation in Products, Materials, or Processes

This Proposed Regulation and Proposed Amendments to the Regulations addresses the issue of withholding on income from California sources by non-resident taxpayers, owners who are non-California business entities. Requiring California nonresidents residing in other states to pay taxes on income earned would not impact innovation in products, materials, or processes because doing so does not put the product, material, or process at risk. The additional tax revenue generated in California would become part of the state's budget and could be applied to new ideas, programs, or change.

10.6 The Benefits to the Health, Safety, and Welfare of California Residents, Worker Safety, and the State's Environment and Quality of Life, Among any Other Benefits Identified by the Agency

The Proposed Regulation and Proposed Amendments to the Regulations would not have any impact on benefits to the health, safety and welfare of California residents, worker safety, and the state's environmental and quality of life. The proposed regulation seeks to address California sourced withholding issues for nonresident taxpayers. Thus, the proposed regulation might change the amount of California income taxes withheld for some nonresident taxpayers. However, it is not expected to have any disparate significant impact on different socioeconomic, geographic, age-specific, or ethnic populations.

11. Alternative Regulations

In addition to the Proposed Regulation and Proposed Amendments to the Regulations, the FTB analyzed the impacts of two regulatory alternatives. One of the regulatory alternatives would require upper-tier entities to withhold on nonresident members directly and the other regulatory alternative removes the pass-through withholding requirement at all levels.

11.1 First Alternative: Upper-tier Pass-Through Entity Withholding Requirement

The FTB examined the option of requiring an upper-tier pass-through entity with a nonresident individual member to withhold on the distributive share of the pass-through entity's California source income. Currently, pass-through entities either file a group return on behalf of their nonresident partners who are engaged in a trade or business in California, or the individual members of the pass-through entity file their individual tax returns. The pass-through entity files the appropriate Schedule K-1 reflecting the member's share of income deductions, credits, withholding, etc., on behalf of all their members. Detail regarding the withholding agent, the payee, income subject to withholding and the amount withheld is taken from the California Form 592-B.

Benefits

There is no benefit to the state from this alternative. It would potentially ease workload for the lower-tier pass-through entities which would not have to track withholding payments made on behalf of their upper-tier pass-through entity.

Costs

There would be an increase in administrative costs in determining which upper-tier pass-through entities have California source income and a nonresident individual member, requiring the upper-tier pass-through entities to be a withholding agent for California income taxes. There is additionally a risk of losing the ability to track California source income through multiple tiers when there is no longer withholding at the lowest level of a pass-through entity structure, which in turn increases the likelihood of noncompliance.

Reason for Rejecting the Alternative

This alternative was rejected because placing the withholding responsibility on the upper-tier pass-through entity with a nonresident individual member would result in a negation of the effort by the FTB to improve administrative efficiency and reduce the number of nonfilers. Requiring withholding on the pass-through entity that did not directly generate the California source income could increase the likelihood of noncompliance. Form 592-Bs, which are filed by the pass-through entity withholding agent, are the mechanism by which an upper-tier pass-through entity is notified of withholding paid on its behalf. If the lower-tier pass-through

entity is no longer required to withhold, then it would not provide a Form 592-B to an upper-tier pass-through entity that would notify the upper-tier pass-through entity of the withholding requirement. By requiring the lower-tier pass-through entity to withhold, the FTB does not need to take the additional steps to determine which upper-tier pass-through entity had a withholding requirement.

11.2 Second Alternative: No Pass-Through Entity Withholding at Any Level

The FTB examined the option of no longer requiring withholding on distributions paid to nonresident partners or members of tiered pass-through entity structures. Currently, the pass-through entity submits a withholding payment on behalf of nonresident partners or members which have received a California source income distribution. Detail regarding the withholding agent, the payee, the income subject to withholding, and the amount withheld is taken from the Form 592-PTE filed by the pass-through entity withholding agent. Under this alternative, withholding payments and the Form 592-PTE would no longer be required and any information regarding the payee including distributions subject to withholding would be lost.

Benefits

There is no benefit to the state from this alternative other than a potential decrease in the FTB's Withholding Services and Compliance Section workload. It would decrease workload for the pass-through entity which would not have to pay withholding, track withholding payments, or file withholding returns. Nonresident filers would likely have less incentive to file California income tax returns without an incentive to claim withholding paid on their behalf, which may decrease payment tracking and filing burden on such nonresidents.

Costs

Currently, because there is a requirement to withhold and file a withholding form for distributions paid to nonresident partners or members of a pass-through entity, the FTB estimates that over \$800 million in PIT and corporation withholding was collected from nonresident partners or members during calendar year 2020. The alternative regulation would result in a loss of these prepayments to the FTB from nonresident pass-through entity partners or members.

Additionally, of the universe of 248,422 PIT and 19,649 corporation nonresident entities with Schedule K-1 reported California source income, the FTB identified 30,070 PIT and 3,223 Corp nonfilers—those issued Schedule K-1s showing earned California source income but have not filed a tax return in the last three years. Some of these nonfilers had withholding payments and information submitted for income distributions. Given the

difficulty in identifying and tracking nonfilers, the loss of additional distribution and withholding information could increase the difficulty of these efforts. Furthermore, current filers subject to withholding might have increased incentive to not file a California tax return, resulting in additional losses in tax revenue in upwards of tens of millions of dollars. The FTB receives additional non-monetary information when nonresident owners file tax returns to claim withholding credits, such as identifying additional taxable income. The loss of this information may result in a reduction in tax revenue.

Reason for Rejecting the Alternative

This alternative was rejected because removing withholding for this population would increase the likelihood of filing noncompliance. The withholding system provides an incentive for the taxpayer to file a California income tax return to claim withholding payments made on his or her behalf. Requiring the filing of withholding forms provides information with respect to nonresident owners with California source income. Without the withholding forms it is difficult for Filing Enforcement to determine if a taxpayer filed as they were required. Providing less information would increase the likelihood of filing noncompliance and increase the burden on Filing Enforcement to determine who is required to file a California income tax return.

12. Additional Cash Flow Impact

The Proposed Regulation and Proposed Amendments to the Regulations could result in short term cash flows beyond those described above. These include acceleration of payments currently made with timely filed returns and amounts that would be over-withheld and refunded when returns are filed. Businesses that are pass-through entities remitting this withholding could lose several months' worth of access to these funds. Since withholding only occurs after an event that generates income, these pass-through entity businesses should not face significant liquidity constraints. At a macro level, the impact of the investment opportunities foregone by these businesses should be roughly offset by the impact of activities funded by earlier state access to these funds.

12.1 The Proposed Regulation and Proposed Amendments to the Regulations Would Not Adversely Impact the California Taxpayer

The FTB expects an increase in tax payments to the state if the Proposed Regulation and Proposed Amendments to the Regulations are adopted. The taxpayers bearing the tax burden of the Proposed Regulation and Proposed Amendments to the Regulations are nonresident filers from other states. Increased compliance by nonresidents levels the playing field and may result in some portfolio rebalancing in which affected assets are

transferred from nonresidents to residents, but any resulting economic impacts are likely to be minor. The impact on the domestic nonresident owner would be limited to the tax paid for income earned on their distributive share of the pass-through entity's California source income. This proposed change would align California pass-through entity withholding requirements with a method utilized by a majority of other states, allowing for the same accounting treatment by California pass-through entities having nonresident members as the treatment of other state pass-through entities. Though this would require some initial short term administrative adjustments, in the long-term it would have the benefit of reducing the complexity of tax compliance and does not result in a change in tax liability.

12.2 The Proposed Regulation and Proposed Amendments to The Regulations Do Not Alter Economic Incentives in the Near Term

Taxpayers who are nonresident filers from outside this state would have additional tax prepayments to California made for income earned in this state. Although the new withholding requirements might be perceived as a negative for nonresidents weighing whether to invest in California pass-through entities, the FTB believes the changes would result in portfolio adjustments between resident and nonresident members to avoid any perceived burdens and thus no net change in aggregate investments. The Proposed Regulation and Proposed Amendments to the Regulations ensure the withholding tax is a more reasonable representation of tax due and should not, therefore, have a significant effect in the near term on any real economic decisions. Though the additional tax revenue would increase output and create new jobs in California, it would not alter taxpayer incentives in decisions pertaining to level of employment, investment, or production. Much of this increase would become part of the state's budget and would be allocated to meet the state's budgetary goals.

12.3 Impact to the State

If the Proposed Regulation and Proposed Amendments to the Regulations are adopted, the revenue gain to the state would result in an increase in output and household earnings, and hundreds of new jobs would be created. Since the state operates under a balanced budget requirement, the increase in revenue would initially increase state government revenues and be allocated in a manner that maintains the Governor's priorities for future budgets. To the extent these revenues are assigned to improve business conditions, or provide taxpayer assistance, there could be some unquantifiable benefit to businesses and California residents.

12.4 Additional Benefits

Since some of these taxpayers are required to file a tax return but don't, adoption of the Proposed Regulation and Proposed Amendments to the Regulations would likely improve

the administrative efficiency of California tax collection process. The Department would be able to collect taxes due to this state which are currently difficult to monitor because of a lack of taxpayer information. Additionally, the Proposed Regulation and Proposed Amendments to the Regulations would not have any direct impact on the health and welfare of California residents, worker safety, and the state's environment.