Jayson Gottman
Franchise Tax Board
Legal Division
P.O. Box 1720
Rancho Cordova, CA 95741

September 16, 2024

Dear Mr. Gottman:

Thank you for submitting the standardized regulatory impact assessment (SRIA) and summary for the proposed regulation on Domestic Pass-Through Entity Withholding, as required in the California Code of Regulations, title 1, section 2002 (a)(1). Comments are based upon the SRIA and other publicly available information.

The proposed regulation would require out-of-state owners of pass-through entities (partnerships, limited liability companies, and corporations organized under Subchapter S) within California to pay periodic income tax withholding based on their shares of the entities' estimated income, whereas current law only requires withholding based on the distributions the owners receive. The regulation would also require that withholding be paid at the highest marginal tax rate (for example, 13.3 percent for the personal income tax) as opposed to 7 percent under current law. It also has other provisions intended to simplify compliance. All these changes would take effect on January 1, 2025. The regulation would apply to people who live in other U.S. states and are sole or part owners of California businesses and would mainly affect the real estate, finance, and professional services sectors. The agency estimates that as a result of being required to withhold, income taxes paid mainly by residents of other states who currently do not file California taxes (despite being legally required to) would increase by $53 million in 2025 and grow slowly thereafter. Revenue accelerations from withholding on current filers would raise revenue by about $35 million in 2025 but just $1.5 million a year from then on. As such the cost of the regulation would fall on out-of-state owners of California businesses, and the benefit would accrue to California residents in the form of increased state revenue. The fiscal impact to the state of the proposed regulation is the same as the cost and the benefit, an increase in income tax revenue. The projected total economic impact from the increased state revenue is about double the fiscal impact. No fiscal impact estimate is provided for local governments, as they do not impose income taxes. There is no estimate of the change in the Franchise Tax Board (FTB)'s administrative costs, although FTB states that the regulation would likely improve administrative efficiency.

Finance generally concurs with the methodology, with the following exceptions. First, the SRIA must estimate the fiscal impact on local governments. With an estimated increase in total industry output in excess of $120 million annually, there would be a quantifiable if modest increase in local sales tax collections.

Second, 1 CCR section 2003 (c) states that costs and benefits shall be separately identified for different groups of individuals if the impact of the regulation will differ significantly among identifiable groups. In this case, recent data on the distribution of adjusted gross income among out-of-state filers claiming California partnership or proprietorship income should be available to identify the extent of any potential disparate impacts.

Third, with regard to the estimation of the revenue acceleration and the adjustments that are made for taxpayer behavioral changes that would offset the increased withholding, the SRIA should provide more basis to justify some of the various assumptions made or be clearer that it was an assumption based on judgment rather than data. For example, on pages 18-19, there is no reasoning provided for the thresholds for increased withholding of $3,000 for personal income taxpayers and $50,000 for corporate income taxpayers (as opposed to higher or lower figures) that would incentivize a taxpayer to accelerate their filing date. As an additional example, on page 19, there is no explanation why all of the $5.1 million in refunds received on extension returns in 2020 would all switch to timely returns under the proposed regulation.

These comments are intended to provide sufficient guidance outlining revisions to the impact assessment. If any significant changes to the proposed regulations during the rulemaking process result in economic impacts not discussed in the SRIA, please note that the revised economic impacts must be reflected on the Standard Form 399 for the rulemaking file submittal to the Office of Administrative Law. Please let us know if you have any questions regarding our comments.

Sincerely,

Somjita Mitra
Digitally signed by Somjita Mitra
Date: 2024.09.16 14:08:38 -07'00'

Somjita Mitra
Chief Economist

cc: Ms. Dee Dee Myers, Director, Governor's Office of Business and Economic Development
Mr. Kenneth Pogue, Director, Office of Administrative Law
Ms. Selvi Stanislaus, Executive Officer, Franchise Tax Board
Mr. John McMahan, Chief Economist, Franchise Tax Board