

## In This Issue:

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California increases payroll tax withholding November 1, 2009, and introduces back-up withholding requirements effective January 1, 2010. This means more work for payroll and accounts payable departments and for employees payrolled in California - potentially smaller net paychecks.

## Cash-Strapped California Adjusts Tax Withholding Requirements - A Concern for All California Employers and Workers

By GJ Stillson MacDonnell

As part of California's annual budget ordeal, rather than enacting new taxes, the legislature enacted (and the Governor signed) various income shifting and tax acceleration provisions. Under ABX4-17, as of November 1, 2009, employers will be using a new state income tax withholding table to increase by 10% the amount of income taxes withheld based on existing claimed exemptions. This law also increases the rate on withholdings for supplemental wages as well as other types of payments such as exercised stock options and bonuses. Under a companion bill, ABX4-18X, as of January 1, 2010, California imposes 7% backup withholding for certain payments to non-employees (*i.e.* independent contractors) where back-up withholding is otherwise generally required under the Internal Revenue Code. In combination, these laws create new obligations on both payroll and accounts payable operations.

### Background

Income taxes withheld by employers are deducted from regular wages and calculated generally based on tax tables prepared by the Franchise Tax Board (FTB) for state income and the Internal Revenue Service (IRS) for federal tax purposes. Taxes withheld for the FTB are remitted to the FTB through the California Employment Development Department (EDD), the California agency that collects all employment taxes. Typically, employees adjust the level of income tax withholding by submitting to their employers an IRS form W-4. California also has its own form, DE-4. Employees can submit different forms reflecting their state and federal personal income tax circumstances. Rarely will the use of either or both forms result in withholding that precisely matches the employee's own annual income tax liability. Ultimately personal tax liability is a matter for the employee.

In an effort to accelerate revenue flow, beginning November 1, 2009, California is adjusting its income tax withholding tax tables by 10%. For example, if bi-weekly state income tax withholding is currently \$500 a pay period on an employee's regular wages, come November 1, such withholding will automatically adjust to \$550.

New special tax rates will also be applied to non-regular or “supplemental” wages payments.<sup>1</sup> For federal tax purposes such supplemental wages are typically subject to 25% flat rate income tax withholding. Under existing California tax law, supplemental wages are generally taxed at a flat 6% while stock option and bonus wages have been taxed at a rate of 9.3%. As of November 1, 2009 these rates are adjusted to 6.6% and 10.23%, respectively.

Also, as part of the budget balancing process, as of January 1, 2010, California is introducing 7% withholding whenever the recipient is otherwise subject to federal backup withholding. Most commonly these non-wage payments subject to potential back-up withholding are any payment otherwise subject to IRS 1099 reporting. Such payments include compensation for services to independent contractors as well as taxable non-wage income, such as taxable payments settling claims or lawsuits.

## Impact of California Changes

These legislative changes impact employers from both a payroll and an accounts payable perspective. Since these are two organizational functions that often operate independent of each other, coordinated review and communications on these new laws is needed.

With respect to pending claims and settlements, additional withholding at the state level may be required on non-wage but otherwise taxable payments made on or after January 1, 2010. As back-up withholding is to be remitted to the FTB rather than the EDD, new forms and procedures will be developed for reporting and transmitting such withholding tax payments.

Payroll services should be loading in the new tables for withholding now, so they will be fully operational by payrolls scheduled for November 1 or later. Testing of such updated software should be conducted before November 1.

As this flat rate adjustment may have no relationship to actual state income taxes, employers can anticipate employees will be potentially flooding payroll departments with revised W-4 and DE-4 forms to “right size” their withholding arrangement. Since nothing in the law forces employees to increase their withholding, an employee can effectively reduce the effect of this law by increasing claimed exemptions, if the new tables would result in excessive tax withholding.

California is proceeding on the assumption that either employees under withhold income taxes through payroll or that employees will not be smart enough to adjust their withholding, and instead give California an interest-free loan of California employees’ income.

ABX4-17 also provides for those who file estimated taxes (typically the self-employed) to also accelerate such payments. Both of these acceleration features raise potential constitutional issues and/or other statutory issues, as in many instances such accelerated revenue receipts exceed an individual’s tax obligations and conflict with other state and/or federal laws obliging an employee to accurately provide for income tax withholding.

Back-up withholding for California purposes will be basically triggered when it is required for federal tax purposes. Generally, in the employment-related context, non-wage payments or payments to independent contractors are potentially subject to back-up withholding. Becoming subject to back-up withholding status is based upon a notice from the IRS to an individual. The IRS form W-9 includes an affirmation that the individual providing the form is not subject to back-up withholding. On a practical level, very few will disclose such back-up withholding status out of ignorance or denia so the actual revenue prospects for California should be modest, at best.

From a payor’s prospective regarding back-up withholding, the obligation to withhold and actual withholding will generally be eliminated, if before remittance the payor receives a completed IRS form W-9 that attests that the payee is not subject to back-up withholding. Nevertheless, this new exercise introduces a potential contingent liability on such payors and it imposes on such payors a new process to integrate into its processing system with regards to payments to vendors or other non-employees. Under federal law, a payor who fails to withhold funds required under IRC back-up withholding has liability for the amount that should have been withheld (currently 28%). Under the new California law, it is unclear whether similar liability has been created.

## Recommendations

- Review with payroll vendors the status of uploading revised withholding tables for regular wage payments to ensure that it will be fully operational for payroll runs November 1, 2009, or later.
- Payroll departments should be prepared to receive W-4, DE-4 amended forms, on or after November 1. Payroll personnel should be prepared to answer employees questions regarding these forms and the new law.
- Supplemental wages withholding rates for California should be updated for use as of November 1, 2009.
- Accounts payable departments need to implement a program for processing California back-up withholding as of January 1, 2010.
- Legal department and outside counsel should note changed withholding rates and back-up withholding requirements and consider these issues when negotiating and drafting settlements and/or preparing for litigation as to non-wage taxable payments to be made November 1, 2009 or thereafter.

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<sup>1</sup> See Littler ASAPs – *IRS Issues Final Regulations on Supplemental Wage Payments and IRS Provides Guidance on Proper Income Tax Withholding for Nine Common Supplemental Wage Payment Scenarios* for further discussion as to what constitutes Supplemental Wages.