

MUNI MARKET UPDATE

December 13, 2010

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CALIFORNIA TO ENFORCE BACKUP WITHHOLDING

To close an estimated annual \$6.5 billion tax gap, the California Franchise Tax Board ("FTB") amended the state's tax code to impose 7% backup withholding on its residents. Although effective January 1, 2010, financial institutions were granted one year by the FTB without penalties for failure to make the necessary withholding — effectively given until January 1, 2011 to implement withholding on distributions subject to California withholding.

Tax Gap

The FTB is responsible for administering two of California's major tax programs: Personal Income Tax and the Corporation Tax, in addition to administering other non-tax programs and delinquent debt collection functions.

Each year, Californians file more than 16 million state personal income tax returns. The Personal Income Tax Program typically generates more than \$40 billion each year for the state's General Fund. California taxes residents on their income from all sources while non-residents are taxed on income derived from California sources.

The tax gap is the difference between what taxpayers owe, under the law, and what they actually pay. FTB estimates that California loses more than \$6.5 billion in tax revenue each year to the tax gap. Tax gap activities include failing to report or underreporting income, overstating deductions, or claiming unwarranted tax credits. Almost 80% of the tax gap is attributable to underreporting of income or over-reporting of deductions, primarily by individuals. Studies conducted by the IRS indi-

cate that taxpayers voluntarily report 96 % of income that is subject to information reporting. That rate increases to 99% when the income is subject to withholding.

The FTB increased its focus on reducing the tax gap to ensure all Californians pay the correct amount of taxes, and created a tax gap plan, "[A Strategic Approach to Reducing California's Tax Gap](#)." The plan, approved by the FTB in December 2006, includes short-, mid-, and long-term strategies to narrow the tax gap and goals to measure the progress of those strategies.

The FTB estimates revenue gains due to the implementation of a 7% backup withholding to be \$32mm for FY2009-10, \$31mm for FY2010-11, \$33mm for FY2011-12, and \$35mm for FY2012-13.

California Residents to Receive Additional 7% Withholding Requirement

Under bill ABX4-18X, as of January 1, 2010, California imposed 7% backup withholding for payments where backup withholding is otherwise generally required under the Internal Revenue Code, with the exception of interest and dividends, and any release of loan funds made by a financial institution in the normal course of business. Typical withholding from a financial services firm would include short-term and long-term capital gain distributions, royalty payments, and gross proceeds from sales and redemptions (including exchanges between funds).

Federal Law

Banks and other businesses that make payments of the type that are required to

CALIFORNIA TO ENFORCE BACKUP WITHHOLDING (CONT'D)

be reported on an information return—i.e., Form 1099 series—may be required to backup withhold on those payments. A payee is required to provide a correct taxpayer identification number ("TIN") to the payer who must report that information on the applicable Form 1099.

Payments subject to backup withholding include interest (Form 1099-INT); dividends (1099-DIV); certain patronage dividends (1099-PATR);

rents, profits, or other gains (Form 1099-MISC); commissions, fees, or other payments to independent contractors (1099-MISC); payments by brokers (1099-B); certain payments by fishing boat operators (1099-MISC); royalty payments (1099-MISC); and certain gambling winnings (W-2G). Payments that are excluded from federal backup withholding include, among other things, real estate transactions, unemployment compensation, and state or local income tax refunds.

Backup Withholding Triggers

Reasons for federal back-up withholding in an account include:

- ◆ No W-9 form certifying a Social Security Number ("SSN") or TIN;
- ◆ A first or second B-Notice restriction (either the name or the SSN/TIN on the account does not match a name and SSN/TIN combination in the records of the Social Security Administration ("SSA") or the IRS). These are

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MUTUAL FUNDS AND MONEY MARKETS

Long-Term Mutual Fund Flows

Total estimated inflows to long-term mutual funds were \$1.04 billion for the week ended Wednesday, December 1, the Investment Company Institute reported.

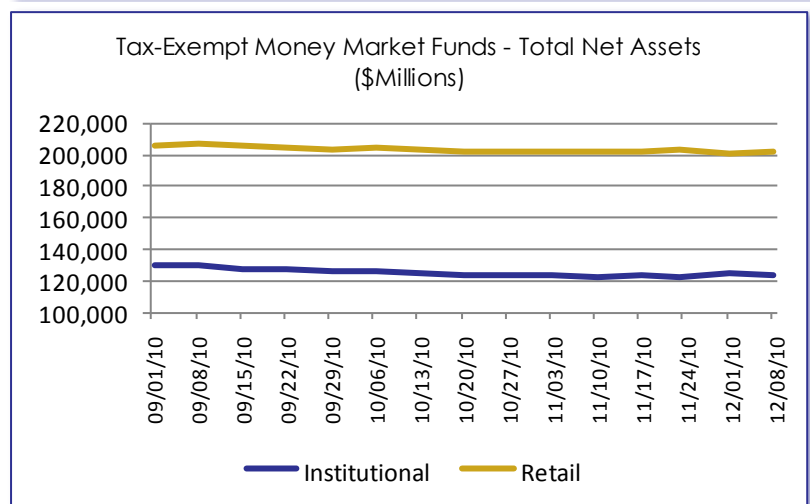
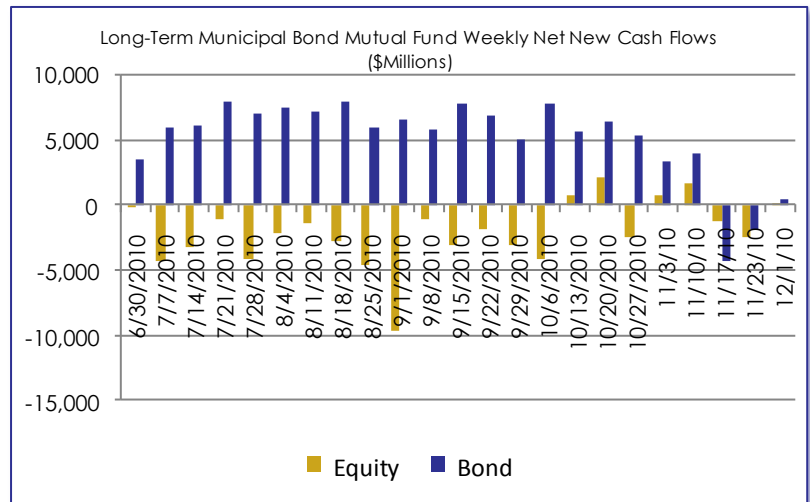
Municipal bond funds had estimated outflows of \$61 million.

Money Market Mutual Fund Assets

Total money market mutual fund assets increased by \$25.27 billion to \$2.836 trillion for the week ended Wednesday, December 8, the Investment Company Institute reported.

Tax-exempt funds increased by \$76 million. Assets of retail money tax-exempt market funds increased by \$1.60 billion to \$202.48 billion. Institutional tax-exempt fund assets decreased by \$1.52 billion to \$123.12 billion. ♣

Source: [Investment Company Institute](#).



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based upon notification from the IRS to the payor that the TIN the payee provided does not match;

- ◆ A C-Notice restriction on the account for the underreporting of interest or dividends on the federal income tax return; or,
- ◆ Payee is required, but fails, to

certify that he or she is not subject to backup withholding.

Civil and Criminal Penalties

Federal law provides civil and criminal penalties for giving false information to avoid backup withholding. This civil penalty is \$500. The criminal penalty, upon conviction, is a fine of up to \$1,000 or imprisonment of up to one year, or both.

Other States

Maine currently imposes backup withholding at 5% on wages, interest, dividends, rent and other payments to nonresident aliens of the United States that are subject to federal withholding. We expect if California's program is successful, other states will implement similar programs to address their own budget gaps. ♣

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