

Guidelines for Pass-Through Entity Withholding

September 21, 2007

Article 16.1 of Chapter 3 of Title 58.1 (§ 58.1-486.1 et seq.) enacted by 2007 Senate Bill 1238 (Chapter 796) requires pass-through entities doing business in the Commonwealth and having taxable income derived from Virginia sources to pay a withholding tax equal to five percent of their nonresident owners' shares of income from Virginia sources. These guidelines are published by the Department of Taxation ("TAX") to provide guidance to taxpayers regarding the new law.

The forms and accompanying instructions for this tax have not yet been developed. Further information will be provided once they are available. While these guidelines and rules will be updated in the future as necessary, it is the intent of TAX to supplement these guidelines with permanent regulations. Nothing in these guidelines shall be construed to affect the current withholding requirements applicable to employers that are provided for in Article 16 (§ 58.1-460 et seq.) of Chapter 3 of Title 58.1.

Definitions

"Income from Virginia sources" means the items of income, gain, loss and deduction attributable to the ownership, sale, exchange or other disposition of any interest in real or tangible personal property in Virginia or attributable to a business, trade, profession or occupation carried on in Virginia or attributable to intangible personal property employed in a business, trade, profession or occupation carried on in Virginia. If the entire business of the pass-through entity is not deemed to have been transacted or conducted within the Commonwealth, then the "income from Virginia sources" means that portion of the pass-through entity's income that has been allocated and apportioned to Virginia in the same manner as corporations.

"Nonresident owner" means any person who is treated as a partner, member, or shareholder of the pass-through entity for federal income tax purposes and, in the case of an individual, is not a domiciliary or actual resident of Virginia, or, in the case of any other entity, does not have its commercial domicile in Virginia.

"Pass-through entity" means any entity, including a limited partnership, a limited liability partnership, a general partnership, a limited liability company, a professional limited liability company, a business trust or a Subchapter S corporation, that is recognized as a separate entity for federal income tax purposes, in which the partners, members or shareholders report their share of the income, gains, losses, deductions and credits from the entity on their federal income tax returns.

"Taxable income from Virginia sources" means the amount of income from Virginia sources allocated to all nonresident owners not exempt under the section titled "Who is Subject to the Withholding Tax" below. The income from Virginia sources should be allocated to the nonresident owners in proportion to their percentage of ownership or

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participation in the pass-through entity or as provided in the partnership agreement or other entity document.

Withholding Tax Requirements

Pass-through entities that have taxable income from Virginia sources and that must allocate any portion of that income to at least one nonresident owner who was a nonresident owner during any portion of the previous taxable year must pay the withholding tax unless an exemption applies. If an owner was a nonresident owner for only a portion of the taxable year, the income allocated to such owner must be prorated by the number of days of residence outside of Virginia in order to determine the amount on which the withholding tax must be paid.

This tax is effective for taxable years beginning on or after January 1, 2008. As a result, pass-through entities will be required to pay this tax for the first time when 2008 returns are filed in 2009.

Who is Subject to the Withholding Tax

Pass-through entities must pay the withholding tax for all nonresident owners, with the following exceptions:

Exception 1: Individuals who are exempt from paying federal income taxes by reason of their purpose or activities or who are exempt from Virginia income taxes. The exemption must apply to the individual's share of the pass-through entity's income. Examples of such exempt individuals are individuals who have been granted diplomatic immunity and individuals who did not have any liability for Virginia income tax in the previous year and who do not expect to have any liability in the current year.

Exception 2: Entities other than individuals and corporations that are exempt from paying federal income taxes by reason of their purpose or activities. The exemption from federal income tax must apply to the entity's share of the pass-through entity's income. Examples of such exempt entities are:

Example 1: Other pass-through entities. These pass-through entities will be responsible for paying the withholding tax on their own nonresident owners' shares of income from Virginia sources. An entity desiring to avail itself of this exemption must furnish a statement on a form to be prescribed by the Tax Commissioner to the pass-through entity stating that it is treated as a pass-through entity under the Internal Revenue Code.

Example 2: Entities exempt by reason of diplomatic immunity or pursuant to treaties between the United States and other countries. An entity desiring to avail itself of this exemption must furnish a statement on a form

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to be prescribed by the Tax Commissioner to the pass-through entity stating that it has diplomatic immunity from federal income tax.

If such an entity is a second pass-through entity, however, it may only be exempt if it agrees to file a Pass-Through Entity Return of Income (Form 502), along with the accompanying schedules and documentation and either file a withholding tax return and pay the applicable tax or file a Unified Nonresident Individual Income Tax Return (Form 765) and pay the applicable tax.

Exception 3: Corporations that are exempt from Virginia income tax. Examples of such exempt corporations are:

Example 1: Certain banks, insurance companies and public utilities that are subject to other taxes in lieu of Virginia income tax. A corporation desiring to avail itself of this exemption must furnish a statement on a form to be prescribed by the Tax Commissioner to the pass-through entity specifying the Virginia tax imposed on it in lieu of Virginia income tax.

Example 2: Corporations exempt from federal income tax under Internal Revenue Code § 501. A corporation desiring to avail itself of this exemption must furnish a statement on a form to be prescribed by the Tax Commissioner to the pass-through entity stating that it is exempt from federal income tax by reason of its purpose or activities and citing the relevant section and subsection of the Internal Revenue Code.

If a nonresident owner claims to be exempt from the withholding tax, the pass-through entity is required to obtain documentation from the nonresident owner setting forth the basis for such exemption. This documentation will be on a form to be prescribed by the Tax Commissioner and must be retained by the pass-through entity with its records.

The determination of nonresident status will be based on the owner's address of record for the pass-through entity unless the pass-through entity has other information relating to the owner's residence or commercial domicile by reason of the owner's participation in management of the pass-through entity. If an owner is also employed by the pass-through entity the information relating to withholding on wages shall also be considered.

The pass-through entity shall provide with its return of withholding tax a list of every individual, corporation and other entity claiming exemption from the withholding tax on a form to be prescribed by the Tax Commissioner. The list shall contain the name, federal social security number, employer identification number or other taxpayer identification number and the address of each nonresident owner claiming exemption, as well as a description of the basis for the claimed exemption.

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Amount of Withholding Tax

The amount of withholding tax is equal to five percent of the share of taxable income from Virginia sources that is allocable to each nonresident owner. In determining the amount of withholding tax, the pass-through entity may apply any tax credits earned by it and allowable under the *Code of Virginia* that pass through to nonresident owners. The credit or credits may not, however, reduce the tax liability of any nonresident owner to less than zero; nor may an unused credit be carried forward on a unified return.

The liability of the pass-through entity for withholding tax is determined annually without regard to whether or not the pass-through entity has actually withheld amounts from any owner's distributions, allocations, or payments.

To the extent that a pass-through entity has paid, or reasonably anticipates paying, Virginia withholding tax with respect to its present and former nonresident owners, the pass-through entity may make such adjustments to such owner's allocations and accounts at such times as it and its owners may agree or as permitted by its operating agreement or charter.

Filing Requirements of the Pass-Through Entity

Pass-through entities that are required to pay the withholding tax must pay the required amount using a form to be prescribed by the Tax Commissioner when the Form 502 must be filed, which is the 15th day of the fourth month following the close of the taxable year. Although the time for filing the Form 502 may be extended, the time for paying the amount of withholding tax due will not be extended.

For taxable year 2008, if a filing extension for Form 502 has been elected, the pass-through entity must pay at least ninety percent of the withholding tax due for the 2008 taxable year in order to avoid a penalty. This payment must be made using a form prescribed by the Tax Commissioner.

In order to avoid a penalty in subsequent taxable years, the pass-through entity must pay either ninety percent of the withholding tax due for the taxable year or one hundred percent of the withholding tax paid for the prior taxable year, if that taxable year was a taxable year of 12 months and the withholding tax was paid for that taxable year. This payment must be made on or before the fifteenth day of the fourth month following the close of its taxable year using a form to be prescribed by the Tax Commissioner.

The remaining portion of the withholding tax due, if any, must be paid at the time the pass-through entity files the Form 502 return on a form to be prescribed by the Tax Commissioner. If the balance due is paid by the last day of the extension period for filing the Form 502 return and the amount of tax due with that return is ten percent or less of the withholding tax due for the taxable year, or if the taxpayer has paid one

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hundred percent of the withholding tax paid for the prior taxable year, no penalty will be imposed.

If the return is filed within the six month extension, but the pass-through entity has failed to pay ninety percent of the tax due by the original due date, then the pass-through entity is subject to an extension penalty of two percent per month. The penalty is applied to the balance of tax due with the return from the original due date through the date the return is filed. The maximum extension penalty is twelve percent of the tax due.

If the return is filed within the six month extension, but the pass-through entity does not pay the full amount of the tax due at the time of filing, the unpaid balance will be subject to a late payment penalty of six percent per month or fraction of a month from the date of filing through the date of payment, up to a maximum of thirty percent. The late payment penalty will be assessed in addition to any extension penalty that may apply.

If the return is filed after the extended due date, the extension provisions do not apply and the pass-through entity is subject to the maximum late filing penalty of thirty percent.

Interest on the unpaid balance of any tax and penalty is charged at the underpayment rate established by § 6621 of the Internal Revenue Code, plus two percent, from the due date until paid. Interest will be accrued on any balance of tax, regardless of whether the ninety percent payment requirement is met.

Statements Provided by the Pass-Through Entity

Pass-through entities that are required to pay Virginia withholding tax must provide each nonresident owner with a statement on a form to be prescribed by the Tax Commissioner that shows:

1. The name, address, federal employer identification number (FEIN), and Virginia account number of the pass-through entity;
2. The amount of Virginia taxable income allocable to the owner, whether or not distributed for federal income tax purposes by the pass-through entity to the nonresident owner;
3. The owner's share of any credits taken into account by the pass-through entity in computing the withholding tax attributable to the nonresident owner; and
4. The amount of withholding tax paid on behalf of the nonresident owner.

The statement must be provided to each nonresident owner on or before the due date of the pass-through entity's Form 502 return, including extensions of time for filing that return, or by a later date as allowed by the Tax Commissioner. A copy of the statement must also be filed with the withholding tax return filed for the applicable taxable year in a manner prescribed by the Tax Commissioner.

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This statement is in addition to the statements that are required to be filed as part of the pass-through entity's Form 502.

Filing Requirements of the Nonresident Owner

The payment of the withholding tax does not relieve the nonresident owner of the obligation to file a Virginia income tax return. Penalty and interest may be imposed on any tax owed by the nonresident owner after credit for the withholding tax paid by the pass-through entity.

Upon filing an individual or corporate income tax return relating to income received from the pass-through entity, the nonresident owner will be allowed a credit for that owner's share of the withholding tax paid by the pass-through entity, provided that the pass-through entity has filed its Form 502, the withholding tax has been paid in full, the nonresident owner has received the Form VK-1 and the statement described in the section titled "Statements Provided by the Pass-Through Entity" above, and the nonresident owner includes a copy of that statement with the income tax return.

Examples of the relationship between the time of filing by the pass-through entity and nonresident owner:

Example 1: The pass-through entity return is due on April 15th, but the entity chooses to extend the time for filing until October 15th. At that time, the entity files the Form 502, pays the withholding tax in full, and sends the VK-1 and statement to the individual nonresident owner. The individual nonresident owner may file a timely return by November 1st and claim the credit on that return.

Example 2: The pass-through entity return is due April 15th, but the entity chooses to extend the time for filing until October 15th. At that time, the entity files the Form 502, pays the withholding tax in full, and sends the VK-1 and statement to the individual nonresident owner. The individual nonresident owner does not receive the VK-1 and the statement before November 1st. Because the individual nonresident owner's return is due November 1st, he must file a return without claiming the credit. After he receives the appropriate documentation, he may file an amended return to claim the credit and receive a refund.

An individual nonresident owner will not be required to file an individual income tax return if the individual consents to be included in the Form 765 filed by each applicable pass-through entity in which he owns an interest and he or she has no other income from Virginia sources.

If an individual nonresident owner is included on one or more Form 765 but has other income from Virginia sources, he or she must file the Nonresident Individual Income Tax Return (Form 763). The individual shall deduct income that has previously been reported on the Form 765.

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Exceptions

Publicly Traded Partnerships

A publicly traded partnership will not be required to pay the withholding tax if it is a publicly traded partnership as defined by § 7704 b of the Internal Revenue Code, as in effect on January 1, 2007, is treated as a partnership for the purposes of federal income taxation, and files Virginia Form 502 and the related schedules.

Disregarded Entities

If a pass-through entity is disregarded for federal purposes, it is also disregarded for purposes of the Virginia income tax. As a result, the disregarded entity is not required to pay this withholding tax. This provision does not affect the existing income tax withholding requirements regarding employees of the disregarded pass-through entity however.

Unified Returns

The pass-through entity will not be required to pay the withholding tax if it files a Form 765. In order to do so, the pass-through entity must obtain the consent of each nonresident owner to be included in the return. Such consent must be on a form to be prescribed by the Tax Commissioner and must indicate that the nonresident owner agrees to be taxed under the following conditions:

1. The pass-through entity must provide a schedule containing the total income of the partnership and the amount attributable to Virginia under either the applicable state apportionment formula, as provided in *Virginia Code* §§ 58.1-408 through 58.1-421, or by using an approved alternative method. This schedule will be on a form to be prescribed by the Tax Commissioner.
2. The return will include each nonresident partner's name, address, social security number and Virginia taxable income attributable to each nonresident partner.
3. The Virginia income tax will be computed at the highest rate specified under *Virginia Code* § 58.1-320 on the partnership's income attributable to the nonresident partners without benefit of itemized deductions, standard deductions, personal exemptions or credit for income taxes paid to states of residence.
4. An owner, officer or employee of the pass-through entity who is authorized to act on behalf of the pass-through entity in tax matters (authorized representative) must sign the unified return. By signing the return, the signer is declaring that he or she is the authorized representative of the pass-through entity and that each participant has signed a consent form authorizing the pass-through entity to act on the participant's behalf in the matter of unified returns and acknowledging the

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participant's understanding and acceptance of all of the terms and conditions of participation in a unified return. The consent form must continue in force indefinitely until revoked in writing by the participant and permit the pass-through entity to file amendments or take other actions concerning the unified return without additional authorization from the participant. The consent forms must be maintained by the pass-through entity and provided to the Department for inspection upon demand.

5. Estimated payments on behalf of those included on a unified return must be made on a unified basis.

Participation in the unified return will indicate the consent of the nonresident owner to be taxed by the Commonwealth of Virginia.

Multiple pass-through entities under common ownership that wish to file a consolidated Form 765 must request permission from the Department of Taxation to do so. Permission will generally be granted.

Undue Hardship

The pass-through entity will not be required to pay the withholding tax if the Tax Commissioner determines that compliance will cause undue hardship. A pass-through entity seeking an exemption on the basis of undue hardship may petition the Tax Commissioner by letter explaining the facts and circumstances creating the hardship.

In addition to any other information that the pass-through entity believes is relevant to its petition for relief, the letter shall provide information to enable the Tax Commissioner to compare and evaluate the cost to the pass-through entity of complying with the withholding tax requirements and the cost to the Commonwealth of collecting income tax from any nonresident owners who do not voluntarily file Virginia income tax returns and pay the tax.

Approved:



Janie E. Bowen
Tax Commissioner