

Virginia Requirement for Withholding Tax by Pass-through Entities

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The withholding tax requirement first applies to taxable years beginning in 2008 and the withholding tax is to be paid with the pass-through entity's Virginia information return.

In 2007, the Virginia General Assembly added § 58.1-486.2 to the Code of Virginia to require pass-through entities (e.g., S corporations, partnerships, and limited liability corporations) doing business in Virginia to “pay a withholding tax.” The statute is somewhat bipolar in that it refers sometimes to “withholding,” as if the entities were required to withhold taxes on distributions to members and sometimes to the payment of a “withholding tax” by the pass-through entity itself. The statutory language gives rise to a number of questions as to the federal and state income tax consequences and raises issues relating to allocations of income in the pass-through entities. The purpose of this article is to analyze the statute and address some of those uncertainties.

Summary of the Statutory Provision

In imposing the withholding tax obligation, Subsection A of § 58.1-486.2 states:

For the privilege of doing business in the Commonwealth, a pass-through entity that has taxable income for the taxable year derived from or connected with Virginia sources, any portion of which is allocable to a nonresident owner, shall pay a withholding tax under this section, except as provided in subsection C.

Subsection B specifies the amount of tax to be paid as:

five percent of the nonresident owner's share of income from Virginia sources of all nonresident owners as determined under this chapter, which may lawfully be taxed by the Commonwealth and which is allocable to a nonresident owner.

Note that the pass-through entity need not be a Virginia organization. All that is required is that the businesses have income from sources in Virginia. Subsection C provides that withholding is not required “for any nonresident owner” who is exempt from Virginia income taxes or where the Virginia tax commissioner grants the entity's petition for exemption from the withholding requirement on the grounds of undue hardship.

Subsections D, F, G, and H contain administrative rules, including, in subsection F, a requirement that each pass-through entity that is required to “deduct and withhold tax” must provide each nonresident owner with a written statement showing the amount of Virginia income allocated by the entity to the nonresident owner and “the amount deducted and withheld as tax under this section.” That provision is awkward since there is no requirement to deduct or withhold taxes. Nevertheless, it is interpreted as meaning that the entity report the amount of withholding tax paid and allocable to each nonresident owner. Subsection E allows each nonresident owner a credit for “that owner's share” of the tax withheld by the entity and states that the nonresident owner's share of the withholding tax shall be treated as distributed to the owner on the earlier of the day the withholding tax was paid by the entity or the last day of the taxable year for which the entity paid the withholding tax. If the nonresident owner is a corporation, subsection F provides that the credit will be applied against the owner-corporation's Virginia corporate income tax liability. However

the subsection does not specify how a non-corporate owner would apply the credit.

The withholding tax requirement first applies to taxable years beginning in 2008 and the withholding tax is to be paid with the pass-through entity's Virginia information return. Thus, pass-through entities first paid the withholding tax with returns filed in 2009.

Compliance Issues

What entities are subject to the requirement?

Any "pass-through entity that has taxable income for the taxable year derived from or connected with Virginia sources, any portion of which is allocable to a nonresident owner" must "pay" the withholding tax. For this purpose a

"pass-through entity" is "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."

A nonresident owner is 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. Taxable income from or connected with Virginia sources is interpreted by the Virginia Department of Taxation to mean the amount of income from Virginia sources allocated to all nonresident owners other than those on whom the withholding tax is not imposed. The department's compliance guidelines (set forth in Public Document 07-150 dated September 21, 2007) state that the entity's income from Virginia sources should be allocated to the nonresident owners in proportion to their percentage of ownership or participation in the pass-through entity or as provided in the partnership agreement or other entity document. In addition, the instructions to Form 502 state that publicly traded partnerships and disregarded entities for federal income tax purposes are not subject to the withholding tax.

Compliance Requirements

The pass-through entity is required to pay the withholding tax (net of credits) to the tax department at the same time its annual information return is due — by the fifteenth day of the fourth month following the end of the entity's tax year. If the entity obtains an extension to file the information return, it is nevertheless required to pay the withholding tax by the due date before extension and, if the amount paid by the due date before extension is less than 90 percent of the withholding tax actually due, the tax department guidelines (but not the statute) state that penalties will be imposed. If the return is filed and the withholding tax is paid by the extended due date, the penalty is 2 percent of the unpaid withholding tax for each month or part of a month between the original due date and the date the return is filed. The maximum extension penalty is 12 percent of the unpaid tax.¹ If the balance of the withholding tax is not paid with the return, a penalty equal to 6 percent for each month or part of a month between the date the return was filed and the date the withholding tax is paid (up to a maximum of 30 percent of the unpaid withholding tax) will be imposed in addition to the extension penalty. If the entity obtains a filing extension and does not file its return by the extended due date, these penalties will not apply and an underpayment penalty equal to 30 percent of the withholding tax will be imposed.²

Each pass-through entity that is required to "deduct and withhold" the withholding tax is also required to provide to each nonresident owner a written statement showing:

- the name, address, federal employer identification number, and Virginia account number of the pass-through entity;
- 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;
- 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
- the amount of withholding tax paid on behalf of the nonresident owner.

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The statement is to be provided on or before the date (including extension) that the entity files its information return (unless the tax commissioner allows the statement to be provided at a later date) and a copy of the statement is to be attached to the return. Again, even though the pass-through entity is not required to “deduct and withhold” taxes, we believe this language is intended to mean each pass-through entity that is subject to the withholding tax must provide this information.

The Internal Revenue Code and many state income tax laws do not impose income taxes on pass-through entities.

The statute allows the pass-through entity to apply “any tax credits allowable under the Code of Virginia to the pass-through entity that pass through to nonresident owners,” provided that the application of credits may not reduce any nonresident owner’s Virginia income tax liability below zero. The statute does not state how tax credits are allocated for this purpose; however, the code sections authorizing specific credits may deal with how credits allowable to pass-through entities are allocated.³

Interpretive Issues

The language of § 58.1-468.2 alternates between imposing a “withholding tax” on the pass-through entity and obligating the pass-through entity to “deduct and withhold” Virginia income tax imposed on the entity’s nonresident owners.

At first glance it might appear that the General Assembly was trying to devise a convenient method to collect taxes otherwise owed by nonresident owners who might have no other connection with Virginia. Absent this statute, the Commonwealth of Virginia has the practical burden of finding nonresident owners (who might not even realize they are subject to tax in Virginia) and assessing and collecting taxes in foreign (i.e., non-Virginia) jurisdictions. The requirement to pay withholding tax, together with the requirement that the entity provide the nonresident owner with a statement, would—in the ordinary at least—collect tax from the nonresident owner and remind the owner of the obligation to

file a Virginia income tax return. The instructions to the pass-through entity information return (Form 502), which state that the entity “must withhold and pay Virginia income tax on behalf of each of its nonresident owners” support the withholding obligation approach.

However, the language of § 58.1-468.2 states that “for the privilege of doing business” in Virginia, a pass-through entity that has income attributable to a nonresident owner shall “pay” (rather than “withhold and pay over”) the withholding tax. Moreover, in its 2009 session, the General Assembly added the following sentence to § 58.1-390.2: “Any taxes imposed on the pass-through entity itself, such as, but not limited to, sales and use taxes, withholding taxes with respect to employees or nonresident owners, and minimum taxes in lieu of income taxes, shall be paid by the pass-through entity.”⁴ The quoted language from § 58.1-468.2, together with the amendment to § 58.1-390.2 indicates that, rather than requiring the pass-through entity to collect tax payable by its nonresident owners, the General Assembly imposed a new tax on the entity itself.

The General Assembly may have been persuaded to impose the tax on the pass-through entity itself because of two 2007 decisions of the Richmond Circuit Court. In *DiBelardino v. Commonwealth* and *Dutton v. Commonwealth* (Docket Nos. CL06-5696; CL06-6291, issued June 22, 2007), the court essentially held that ownership in a pass-through entity (at least one organized in another jurisdiction) does not, in itself, create sufficient nexus to permit Virginia to tax a nonresident owner’s share of the entity’s Virginia sourced income.⁵

Imposition of the withholding tax directly on the pass-through entity will have a significant impact on all of the owners, Virginia residents as well as nonresidents, of every pass-through entity doing business in Virginia and having nonresident owners.⁶ The Internal Revenue Code and many state income tax laws do not impose income taxes on pass-through entities. Instead, the entity determines its taxable income or loss under the applicable tax law and allocates its income among its owners, either in proportion to the owners’ relative interests or as provided in a partnership, operating or other agreement of the owners. The owners then take their respective shares of the entity’s income into account in determining their individual taxable incomes and income taxes. However, non-income taxes, such as property taxes, sales and use taxes, and the employer’s share of Federal Insurance

Contributions Act taxes are generally imposed on the entity itself.

For federal tax purposes, taxes that are imposed on the entity as opposed to its owners are deducted in determining the entity's income. Thus, if the Virginia withholding tax is a tax on the entity rather than merely a collection obligation, the entity should deduct the withholding tax in determining the income to be allocated among all its owners for federal income tax purposes. This would result in a smaller amount of income allocated to each member — resident and nonresident alike.

It is unlikely that many, if any, partnership or operating agreements currently take account of the withholding tax in their income allocation or distribution provisions. Typically, allocations and distributions are made in proportion to percentage ownership. Thus, if the withholding tax is a tax on the entity, it will result in reduced allocations, at least for federal income tax purposes, to all owners, whether Virginia residents or not. And where, as is the case under many partnership or operating agreements, distributions follow income allocations, the withholding tax would also result in smaller distributions to all owners, whether Virginia residents or not.

As a simple example, consider a pass-through entity owned 60 percent by Virginia residents and 40 percent by nonresidents, which has \$1,000 of net income (all sourced to Virginia) before the Virginia withholding tax and which allocates income according to percentage ownership. Prior to consideration of the Virginia withholding tax, the income allocable to the Virginia residents would be \$600 and the income allocable to nonresidents would be \$400. Also assume that the Virginia withholding tax is 5 percent of the \$400 allocated to nonresidents (but see the discussion below), or \$20. If the withholding tax is imposed on the entity, the tax is deductible in determining the entity's federal income, therefore the entity's income for federal tax purposes would be reduced to \$980, with \$588 allocated to the residents and \$393 allocated to the residents.

Whether the withholding tax deduction will similarly reduce the entity's income for Virginia purposes depends on whether the withholding tax is an income tax. Virginia income taxes are not deductible in determining Virginia taxable income. Thus, if the withholding tax is an income tax, it is not deductible in determining the entity's income for Virginia income tax purposes and in the above example, the entity's Virginia income would be \$1,000, the resident owners' \$600 and

the nonresident owners' \$400 and the amount of tax to be withheld would be \$20 as assumed above.

On the other hand, if the withholding tax is not an income tax, then it should be deductible in determining the entity's income for Virginia as well as federal tax purposes. In this case the withholding tax is determined by the equation $T = (.05nI)/I + .05n$, where T represents the amount of the withholding tax, I the amount of income before application of the withholding tax and n the percentage of income to be allocated to nonresidents. In the above example, $T = (.05 \cdot 40 \cdot \$1,000) / .05 \cdot 40 = \19.61 and the entity's income to be allocated among the owners is \$980.39 for federal and Virginia purposes. The allocation to resident owners is 60 percent of \$980.39 or \$588.23 and the amount allocated to nonresident is \$392.16.

The situation is further complicated because Virginia provides a credit for the withholding tax but allocates it entirely to nonresident owners. Thus, under either scenario of the example, resident owners must pay all of the Virginia income tax on income allocated to them, whereas nonresident owners receive a credit for the withholding tax against the Virginia tax on income allocated to them. Assuming the maximum Virginia tax rate of 5.75 percent, under the first scenario in the above example (i.e., the withholding tax is an income tax), resident owners have \$600 income for Virginia purposes and pay \$35 Virginia income tax while nonresidents have \$400 income but, because of the \$20 credit, pay only \$3 of Virginia income tax. In the second scenario (the withholding tax is not an income tax), resident owners have \$588.23 of income and pay \$33.82 of Virginia income tax, whereas nonresidents have \$392.16 of income but, after the credit pay only \$2.94 of Virginia income tax.

Pass-through entities affected by this benefit shift might desire to change their allocation and distribution methods to allocate the entire withholding tax to the nonresident owners so that, in the above example, resident owners would continue to be allocated \$600 with no withholding tax, while the entire withholding tax (and the associated credits) would be included in the \$400 allocated to the nonresident owners. However, if the governing agreement requires unanimous consent for an amendment, the nonresident owners will be able to block any attempt to change the allocation (which, as shown in the above example, results in a relative benefit to the nonresidents). And if the entity is an S corporation, allocation

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must be in proportion to the owners' respective share ownership and no amendment of the allocation method will be possible without modifying relative share ownership.

At least nine states other than Virginia impose a withholding tax obligation on pass-through entities having foreign owners.⁷ Except for Ohio, whose statutes state that the tax is levied on the entity itself, each of the other states' statutes require the pass-through entity to withhold tax on behalf of the non-resident owner rather than imposing the tax on the entity itself.⁸

Conclusion

Understanding and applying this statute will be significantly enhanced if the statute is amended to eliminate its bipolar nature. The statute should either refer to the "withholding tax" or require withholding as do most other states. Because it appears Virginia has chosen not to go that route, in view of *DiBelardino*, the statute must be revised to clarify. Beyond that, the clarifications will be more appropriate in either instructions or in releases by the tax department. Finally, owners of pass-through entities may wish to amend their partnership agreements, operating agreements or other entity documents to clearly spell out how the payment of the withholding tax, as well as the related deduction, will be allocated for book purposes as well as for tax purposes.¹⁰ ■

Endnotes:

- 1 These penalties are similar to the penalties imposed on individuals and corporations, which pay less than the minimum required estimated income tax. *See*, Code of Virginia §§ 58.1-344B and 58.1-453B
- 2 This is equal to the maximum penalty imposed on individuals and corporations for underpayment of income tax. *See*, Code §§ 58.1-347 and 58.1-450.
- 3 For example, § 58.1-334 of the Code requires that the credit for the purchase of conservation equipment be allocated among the owners of a pass-through entity in proportion to their ownership or interest in the entity, whereas § 58.1-339.2 allows historic rehabilitation credits to be allocated either in proportion to ownership interests or as otherwise agreed by the owners in writing.
- 4 Prior to the 2009 amendment § 58.1-390.2 provided: "Except as provided for in this article, owners of pass-through entities shall be liable for tax under this chapter only in their separate or individual capacities."
- 5 The *DiBelardino* and *Dutton* cases involved two nonresident (and nonmanagement) owners of a limited liability corporation organized in

Delaware. The LLC received proceeds from settlement of a patent dispute, which the Virginia Department of Taxation determined (and the court agreed) was income properly sourced in Virginia. The department attempted to tax DiBelardino and Dutton on their respective shares of the LLC income. Because DiBelardino owned two bed and breakfasts in Norfolk (apparently unrelated to the LLC), the court held that Virginia could tax his share of the LLC income. On the other hand, Dutton had no connection with Virginia other than ownership in the LLC, and the court found that Virginia was prohibited from taxing him by the due process and commerce clauses of the U.S. Constitution. Although the court's constitutional reasoning may be questionable (and raises issues that are beyond the scope of this brief article), the decision likely influenced the General Assembly to impose the withholding tax on the pass-through entity.

- 6 Other than single member entities, which are excluded from the definition of pass-through entities and perhaps, publicly traded entities, which seem to have been administratively exempted from the withholding tax.
- 7 Va. Code §§ 58.1-322d.1. (individuals), 58.1-402B.4. (corporations)
- 8 The states are: Arkansas (ACA §26-51-919), Kentucky (KRS §141.206), Maine (36 MRS § 5250-B), Montana (Montana Code § 15-30-1113), New Mexico (NM Stat. Ann. § 7-3-12), Ohio (ORC §§ 5733.41 and 5747.41), Oklahoma (68 Okla. St. § 2385.30), Oregon (ORS § 314.781), and Rhode Island (RI General Laws § 44-11-2.2).
- 9 ORC Ann. 5733.41 ("For the same purposes for which the tax is levied under section 5733.06 of the Revised Code, there is hereby levied a tax on every qualifying pass-through entity having at least one qualifying investor that is not an individual."); ORC Ann. 5747.41 ("For the same purposes for which the tax is levied under section 5747.02 of the Revised Code, there is hereby levied a withholding tax on every qualifying pass-through entity having at least one qualifying investor who is an individual"). Notwithstanding this language, the authors understand that Ohio treats the tax as being imposed on the owner(s) rather than on the entity itself.
- 10 Montana's statute allows the pass-through to file a statement from a nonresident owner in which the owner agrees to file Montana tax returns, pay Montana income tax and submit to personal jurisdiction in Montana for the purpose of collecting income tax on its share of the entity's Montana income instead of withholding. Montana Code § 15-30-1113(1)(a).