

Guidelines for Pass-Through Entity Withholding

***Once finalized, these Guidelines will supersede the Guidelines for Pass-Through Entity Withholding that were issued by the Department on September 21, 2007 (Public Document 07-150).*

Procedural History

During the 2007 session, the Virginia General Assembly enacted Senate Bill 1238, which was codified as Article 16.1 of Chapter 3 of Title 58.1 (*Va. Code* § 58.1-486.1 et seq.). This legislation imposes a withholding tax on any pass-through entity doing business in the Commonwealth and having taxable income derived from Virginia sources, in an amount equal to five percent of its nonresident owners' share of income from Virginia sources. The pass-through entity withholding tax became effective for taxable years beginning on or after January 1, 2008.

These guidelines are intended to provide updated guidance to taxpayers regarding the pass-through entity withholding requirements. Nothing in these guidelines shall be construed to affect the current withholding requirements applicable to employers provided in Article 16 of Chapter 3 of Title 58.1 (*Va. Code* § 58.1-460). These guidelines supersede the Guidelines for Pass-Through Entity Withholding issued by the Department on September 21, 2007 (Public Document 07-150). As necessary, additional guidelines will be published and posted on the Department's website, www.tax.virginia.gov.

These guidelines represent the Department's interpretation of the relevant laws. They do not constitute formal rulemaking and hence do not have the force and effect of law or regulation. In the event that the final determination of any court holds that any provision of these guidelines are contrary to law, taxpayers who follow these guidelines will be treated as relying on erroneous written advice for purposes of waiving penalty and interest under *Va. Code* §§ 58.1-105, 58.1-1835, and 58.1-1845. To the extent there is a question regarding the application of these guidelines, taxpayers are encouraged to write to the Department and seek a written response to their question.

This revision of the guidelines is expected to be effective for taxable years beginning on or after January 1, 2015.

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 a pass-through entity is not deemed to have been transacted or conducted within the Commonwealth, then "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.

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“Investment pass-through entity” means any pass-through entity that meets the following criteria: i) substantially all of the pass-through entity’s assets consist of intangible property; ii) all of the pass-through entity’s income is from interest, dividends, and capital gains from the sale of intangible property; iii) if the pass-through entity owns any real or tangible personal property, such property is not held for the production of income; and iv) the pass-through entity is not engaged in a trade or business in Virginia. For purposes of this definition, “substantially all” means 95 percent or more.

“Nonresident owner” means any person who is treated as a partner, member, or shareholder of a 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 income from Virginia sources that would be subject to Virginia income tax if the entity were not a pass-through entity.

Pass-Through Entity Electronic Filing Mandate

Beginning on January 1, 2015, effective for Taxable Year 2014 and thereafter, pass-through entities are required to file their returns and the accompanying schedules, and make any tax payments electronically. The electronic filing mandate does not apply to returns for taxable years prior to Taxable Year 2014.

If a pass-through entity is unable to file or pay electronically, it may request a waiver. All requests for a waiver must be submitted to the Tax Commissioner in writing. Waivers will only be granted if the Tax Commissioner finds that the electronic filing mandate creates an unreasonable burden on the pass-through entity.

For more information regarding the pass-through entity electronic filing mandate, see the Form 502 instructions or visit the Department’s website.

Pass-Through Entity Withholding Tax Requirements

A pass-through entity must pay the pass-through entity withholding tax if:

- It has taxable income from Virginia sources;

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- It must allocate any portion of such income to at least one nonresident owner who was a nonresident owner during any portion of the previous taxable year; and
- No 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 based on the number of days of residence outside of Virginia in order to determine the amount of income on which the pass-through entity withholding tax must be paid.

A pass-through entity must pay the pass-through entity withholding tax for all of its nonresident owners unless an exemption applies. Exemptions may be based on either the nonresident owners' status or the pass-through entity's status.

Exemptions Based on the Nonresident Owners' Status

i. Individuals and Entities Exempt from Taxation

Individuals and entities that are exempt from federal or Virginia income taxation are exempt from the pass-through entity withholding tax. The exemption from federal or Virginia income taxation must apply to the individual or entity's share of the pass-through entity's income. Examples include:

Example 1: Individuals and entities that are exempt from federal income taxation by reason of diplomatic immunity or pursuant to treaties between the United States and other countries as certified by the United States Department of State.

Example 2: Certain banks, insurance companies, and public utilities that are organized as corporations, and that are subject to other taxes in lieu of Virginia's corporation income tax.

Example 3: Corporations exempt from federal income taxation under Internal Revenue Code § 501.

ii. Individuals with No Virginia Income Tax Liability

Individuals who did not have a Virginia income tax liability in the previous year and who do not expect to have any liability in the current year are exempt from the pass-through entity withholding tax.

iii. Tiered Pass-Through Entities

If a pass-through entity (the "upper-tier entity") owns another pass-through entity (the "lower-tier entity"), the lower-tier entity should not withhold on the Virginia income

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allocable to the upper-tier entity. Rather, an upper-tier entity must file Form 502 (and any accompanying schedules and documentation) on its own behalf to reflect any income attributable to the lower-tier entity. The upper tier entity must either pay the pass-through entity withholding tax on income allocable to its nonresident owners for income received from the lower-tier entity or file Form 765 on behalf of such nonresident owners. In cases where there are more than two tiered pass-through entities, the tax must be withheld by the highest tiered entity.

iv. Individuals Included in Composite Returns

Qualified nonresident owners included in a Virginia composite return (Form 765) are exempt from the pass-through entity withholding requirements for income allocable to that pass-through entity. For purposes of inclusion in a Virginia composite return, a “qualified nonresident owner” is a natural person who:

- Is a direct owner of the pass-through entity filing the composite return; and
- Is a nonresident of Virginia with Virginia source income for the taxable year from the pass-through entity filing the composite return.

A pass-through entity may not include a corporation or a pass-through entity in a Virginia composite return. A pass-through entity is required pay the pass-through entity withholding tax for such nonresident owners, and for individual nonresident owners who are not included in the composite return.

For taxable years prior to 2014, a pass-through entity was required to obtain the consent of each nonresident owner in order to file a composite return. Effective for taxable years beginning on or after January 1, 2015, a pass-through entity may file a composite return for only a portion of its qualified nonresident owners, provided that the pass-through entity pays the pass-through entity withholding tax for any qualified nonresident owners who are not included in the composite return.

Requirements for Filing a Composite Return: To file a composite return, a pass-through entity must meet the following requirements:

- The pass-through entity must provide a completed copy of Schedule VK-1 to each qualified nonresident owner included in the composite return.
- The Virginia income tax on the composite return must be computed using the highest rate specified under *Va. Code* § 58.1-320 on the partnership's income attributable to the qualified nonresident owners included on the composite return without the benefit of itemized deductions, standard deductions, personal exemptions, credits for income taxes paid to states of residence, any tax credit carryover amounts, or any other tax credits that are not attributable to the pass-through entity.

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- The pass-through entity must obtain a signed consent form from each participating qualified nonresident owner indicating the owner's consent to inclusion in the composite return.
- The composite return must be signed by 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. By signing the composite return, the signer is declaring that he or she is an 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 composite returns and acknowledging the participant's understanding and acceptance of all of the terms and conditions of participation in a composite return.
- The pass-through entity must make estimated payments on behalf of the qualified nonresident owners included on a composite return.

Minimum Requirements for Consent Forms: A qualified nonresident owner's participation in the composite return will indicate his or her consent to be taxed by the Commonwealth. The consent form obtained by the pass-through entity must include the qualified nonresident owner's name, address, and Social Security number. The pass-through entity must maintain such forms and provide them to the Department on request. At a minimum, each consent form must set forth that the qualified nonresident owner:

- Consents to being included in the composite return;
- Consents to having his or her Virginia income tax computed using the highest rate specified under *Va. Code* § 58.1-320 on the partnership's income attributable to the qualified nonresident owners included on the composite return without the benefit of itemized deductions, standard deductions, personal exemptions, credits for income taxes paid to states of residence, or any other tax credits that are not attributable to the pass-through entity;
- Permits the pass-through entity to file amended returns or take other actions concerning the composite return without additional authorization; and
- Understands that such consent continues in force indefinitely until revoked in writing.

Pass-Through Entities under Common Ownership: Multiple pass-through entities under common ownership that wish to file a single composite return will be allowed to file such return without prior approval from the Department. For purposes of this provision, "common ownership" means that multiple pass-through entities are owned by a substantially identical group of partners, members, or shareholders, and "substantially identical" means 80 percent or more.

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A pass-through entity may only participate in a single composite return with pass-through entities under common ownership if it obtains signed forms from all qualified nonresident owners included in the composite return indicating their consent to be included in a single composite return with pass-through entities under common ownership. Each pass-through entity participating in a single composite return with other pass-through entities under common ownership must maintain such forms and provide them to the Department upon request.

Nonresident Owners Claiming an Exemption

If a nonresident owner claims to be exempt from the pass-through entity withholding tax, the pass-through entity is required to obtain a signed form from the nonresident owner setting forth the basis for such exemption that declares, under penalty of law, that the information provided by the nonresident owner is true, correct, and complete. This form must be retained by a pass-through entity with its records, and must be provided to the Department on request. Such exemption will generally remain in effect until revoked or until the exemption claimed in the document no longer applies. However, individuals claiming an exemption because they have no Virginia income tax liability must provide a signed exemption form for each taxable year.

The determination of nonresident status will be based on the owner's address of record for a 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 the management of the pass-through entity or otherwise. If an owner is also employed by the pass-through entity, the information relating to withholding on wages will also be considered.

A pass-through entity is required to include a list of all of the nonresident owners that are claiming an exemption from the pass-through entity withholding tax when filing Form 502. The list is required to contain the name, social security number, employer identification number or other taxpayer identification number, and the address of each nonresident owner claiming an exemption, as well as a description of the basis for the exemption claimed.

A pass-through entity must still prepare a Schedule VK-1 for any nonresident owner that claims a valid exemption from the pass-through entity withholding tax, and the pass-through entity must either submit a copy of the Schedule VK-1 to the Department or include such nonresident owner in the pass-through entity's Schedule VK-1 Consolidated.

Exemptions Based on the Pass-Through Entity's Status

i. Disregarded Entities

If a pass-through entity is disregarded for federal income tax purposes, it is also disregarded for Virginia income tax purposes. As a result, such entity is not required to

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file Form 502 or pay the pass-through entity withholding tax. However, this does not affect the existing income tax withholding requirements regarding employees of such entity.

ii. Publicly Traded Partnerships

A partnership is not required to pay the pass-through entity withholding tax if it is a publicly traded partnership as defined by Internal Revenue Code § 7704(b), as in effect on January 1, 2007, it is treated as a partnership for federal income tax purposes, and it files Form 502 and the related schedules.

iii. Undue Hardship

A pass-through entity is not required to pay the pass-through entity 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 that will enable the Tax Commissioner to compare and evaluate the cost to the pass-through entity of complying with the pass-through entity withholding tax requirements, and the cost to the Commonwealth of collecting income tax from nonresident owners that do not voluntarily file Virginia income tax returns and pay the tax.

Example 4: A pass-through entity that distributes non-cash income and is unable to pay the pass-through entity withholding tax unless it liquidates some or all of its assets may request an exemption from the pass-through entity withholding tax on the basis of undue hardship.

iv. Four or Fewer Dwelling Units

A pass-through entity that owns and leases four or fewer dwelling units is not required to withhold for any nonresident owner.

v. Investment Pass-Through Entity

The income from the intangible property held by an investment pass-through entity is not income from Virginia sources, and such entities are not required to pay the pass-through entity withholding tax or file Form 502.

The person who manages the investments of an investment pass-through entity will be subject to tax in Virginia if the manager carries on any business in Virginia. In such cases, the manager is required to file the appropriate return. The fact that the manager of an investment pass-through entity is located in Virginia will not cause the income of the investment pass-through entity to be considered income from Virginia sources,

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regardless of whether the manager is one of the owners of the investment pass-through entity or an unrelated party.

The income, deductions and other attributes of an investment pass-through entity will pass through to its owners and be included in their federal adjusted gross income or federal taxable income. The impact of such income on the Virginia tax liability of the owner is as follows:

- Individuals who are residents of Virginia will file an individual income tax return reporting their federal adjusted gross income. Any income from an investment pass-through entity that is included in federal adjusted gross income will not be considered income derived from another state based solely on the fact that the state in which the investment pass-through entity is organized or managed is a state other than Virginia.
- Nonresident individuals will not be required to file a nonresident Virginia income tax return solely because of income from an investment pass-through entity. If they have other income from Virginia sources requiring the filing of a nonresident income tax return, the income derived from an investment pass-through entity will not be considered income from Virginia sources even if the investment pass-through entity is organized under Virginia law or managed by a person located in Virginia.
- Corporations will not be required to file a Virginia income tax return solely because of income from an investment pass-through entity. If a corporation has other income from Virginia sources requiring the filing of a Virginia income tax return, the income derived from an investment pass-through entity will not be considered gross receipts attributable to Virginia for purposes of the sales factor solely because an unrelated party located in Virginia is managing the intangible assets of the investment pass-through entity or otherwise conducting an income-producing activity on behalf of the investment pass-through entity.

If the intangible assets of an investment pass-through entity include patents, copyrights, trademarks and similar assets, any royalties or other payments by a corporate owner or its affiliated entities to the investment pass-through entity with respect to such assets may be subject to the addback requirements of *Va. Code* § 58.1-402 C(8), or the equitable adjustment provisions of *Va. Code* § 58.1-446.

Amount of Pass-Through Entity Withholding Tax

The pass-through entity 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 pass-through entity withholding tax due, a pass-through entity may apply any Virginia tax credits earned by the entity that pass through to its nonresident owners. Such credits may not reduce the tax liability of any nonresident

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owner to less than zero; nor may an unused credit be carried forward on a composite return.

The amount of pass-through entity withholding tax due is determined annually without regard to whether a 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, the pass-through entity 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 pass-through entity withholding tax must pay the amount of tax due by the fifteenth day of the fourth month following the close of the taxable year. Although the time for filing Form 502 will automatically be extended for six months, the time for paying the amount of pass-through entity withholding tax due will not be extended.

Penalties and Interest

i. Extension Penalty

If Form 502 is filed within the six month extension, but the pass-through entity failed to pay ninety percent of the tax due or one hundred percent of the pass-through entity withholding tax paid for the prior taxable year by the original due date, the pass-through entity will be subject to an extension penalty of two percent per month. The penalty will be applied to the balance of tax due with the return from the original due date through the date of full payment. The maximum extension penalty is twelve percent of the tax due.

ii. Late Filing Penalty

If Form 502 is filed after the extended due date, the extension provisions will not apply and the pass-through entity will be subject to the maximum late filing penalty of \$1,200.

iii. Late Payment Penalty

If any payment is not made in full when due, the unpaid balance will be subject to a late payment penalty of six percent per month or fraction of a month from the due date through the date of full payment, up to a maximum of thirty percent. For any month, or fraction thereof, for which the pass-through entity was subject to the late payment penalty and the late filing penalty, the greater of the two penalties will apply.

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iv. Interest

Interest on the unpaid balance of any tax or penalty is charged at the underpayment rate established by *Va. Code* § 58.1-15 from the due date until paid. Interest will be accrued on any balance of the assessment.

Application of Corporate Allocation and Apportionment

In accordance with P.D. 95-19 (2/13/1995), 95-263 (10/16/1995), and 99-76 (4/19/1999), a pass-through entity must include its proportionate share of property, payroll, and sales for purposes of determining its Virginia apportionment factor. The pass-through entity should, therefore, generally allocate and apportion income as prescribed in *Va. Code* §§ 58.1-407 through 58.1-420.

i. Modified Method of Apportionment for Manufacturing Companies

Effective for taxable years beginning on and after July 1, 2011, a pass-through entity that qualifies as a manufacturing company may elect to use the modified method of apportionment provided in *Va. Code* § 58.1-422. For more information regarding the modified method of apportionment for manufacturers, see the Single Sales Factor Election for Manufacturers Guidelines (P.D. 13-6).

Pursuant to Treasury Regulation § 1.703-1(b), elections affecting the computation of income derived from a partnership, including elections of methods of accounting, are to be made by the partnership and not by the partners separately. All partnership elections are applicable to all partners equally, but no election made by a partnership will apply to any partner's non-partnership interests.

The election to use the modified method of apportionment for manufacturing companies can be made by any shareholder, partner, or member who is authorized by law to sign federal tax returns for the pass-through entity. Once a shareholder, partner, or member makes the election on the pass-through entity's tax return, the election is valid and the Department will not provide administrative relief for members who do not agree with the election.

ii. Modified Method of Apportionment for Retail Companies

Effective for taxable years beginning on and after July 1, 2012, a pass-through entity that qualifies as a retail company is required to use the modified method of apportionment specified in *Va. Code* § 58.1-422.1.

iii. Alternative Method of Allocation and Apportionment

A pass-through entity is generally required to allocate and apportion its income using the statutory method as provided in *Va. Code* §§ 58.1-407 through 58.1-420. A pass-through entity seeking to use an alternative method of allocation and apportionment

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must follow the procedure set forth in 23 VAC 10-120-280, and receive permission from the Department to use such method. The Department will only grant permission to use an alternative method of allocation and apportionment in extraordinary circumstances.

Filing Requirements for Nonresident Owners

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

Nonresident owners may claim a credit on their individual or corporate income tax returns for the amount of pass-through entity withholding tax paid on their behalf by a pass-through entity, provided that the pass-through entity filed Form 502, the pass-through entity withholding tax has been paid in full, the nonresident owner has received Schedule VK-1, and the nonresident owner provides a copy of Schedule VK-1 to the Department.

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

Example 5: Form 502 is due on April 15th, but the entity chooses to extend the time for filing until October 15th. At that time, the pass-through entity files Form 502, pays the pass-through entity withholding tax in full, and sends Schedule VK-1 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 6: Form 502 is due on April 15th, but the pass-through entity chooses to extend the time for filing until October 15th. At that time, the entity files Form 502, pays the pass-through entity withholding tax in full, and sends Schedule VK-1 to the individual nonresident owner. The individual nonresident owner does not receive Schedule VK-1 before November 1st. Because the individual nonresident owner's return is due on November 1st, he must file a return without claiming a credit for withholding tax paid. After he receives the appropriate documentation, he may file an amended return to claim the credit.

An individual nonresident owner will not be required to file an individual income tax return if the individual is included in Form 765 and he has no other income from Virginia sources. This provision does not transfer the liability for the tax to the pass-through entity, but simply relieves the nonresident partners from the responsibility of having to file Virginia nonresident individual income tax returns.

If an individual nonresident owner is included on a Form 765 for any pass-through entity but has other income from Virginia sources, he is also required to file Form 763. The

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individual may take credit on Form 763 for any income tax paid in conjunction with Form 765.

Additional Information

These guidelines are available online in the Laws, Rules & Decisions section of the Department's website, located at www.tax.virginia.gov. For additional information, please contact the Department at **(804) 367-8037**.

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