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Require Withholding From Nonresident Members Of Pass-Through Entities (General Fund Taxes -- Individual and Corporate Income Taxes)

[LFB 2005-07 Budget Summary: Page 172, #1]

CURRENT LAW

Under current law, partnerships, and limited liability companies (LLCs) treated as partnerships, are not subject to the state income or franchise tax. Instead, partners or LLC members are required to individually file Wisconsin tax returns and pay tax based on each person's share of the income allocable to services performed, business transacted, or property located in Wisconsin. The share of the organization's income is "passed through" to the members, and it is the members who pay tax on the income, rather than the organization itself.

Similarly, shareholders of tax-option corporations are subject to Wisconsin individual income tax on their share of the corporation's Wisconsin income. Shareholders must file a Wisconsin tax return and pay the tax due on the taxpayer's share of the corporation's Wisconsin income. However, if a shareholder of a tax-option corporation with Wisconsin income does not file a return and pay the tax due to Wisconsin, the corporation may be taxed on that shareholder's share of the corporation's Wisconsin income. Nonresident beneficiaries of estates and trusts may also be subject to Wisconsin taxation if income is passed through to the beneficiary from an estate or trust.

GOVERNOR

For tax years beginning on or after January 1, 2005, require a pass-through entity that has Wisconsin income for the tax year that is allocable to a nonresident partner, nonresident member, nonresident shareholder, or nonresident beneficiary of an estate or trust to pay withholding taxes. Specify that "pass-through entity" would mean partnerships, LLCs, tax-option corporations, and estates or trusts treated as pass-through entities for federal income tax purposes. (Under the bill,

LLCs treated as sole-proprietors or corporations for federal tax purposes would not be pass-through entities). A nonresident would be: (a) an individual not domiciled in the state; or (b) a partnership, LLC, or corporation whose commercial domicile is outside the state; or (c) an estate or trust that is nonresident under state law. The amount of withholding would equal the partner's, member's, shareholder's, or beneficiary's share of income attributable to Wisconsin multiplied by: (a) if the recipient is an individual, estate, or trust, the highest state individual income tax rate for the taxable year for a single individual (6.75%); or (b) for a partnership, LLC, or tax-option corporation, the highest corporate tax rate (7.9%) for the taxable year. Members of pass-through entities that are also pass-through entities would be subject to the same withholding requirements.

Withholding would not be required if the person was exempt from income taxation, was a joint venture not treated as a partnership under federal law, or if the person had no other source of Wisconsin income and the person's share of income from the pass-through entity was less than $1,000. In the case of a person exempt from taxation, a pass-through entity would be permitted to rely on a written statement from the person claiming to be exempt, as long as the pass-through entity attached a copy of such statement to its tax return for the taxable year and the statement included the following: the name, address, federal employer identification number, and reason for claiming an exemption for each person claiming to be exempt from the income tax.

Each pass-through entity would be required to pay the amount withheld according to the following schedule: (a) for tax-option corporations, by the 15th day of the third month following the close of the tax year; and (b) for partnerships, LLCs, estates, and trusts, by the 15th day of the fourth month following the close of the tax year.

If the pass-through entity had an extension of time to file its tax return, then the tax withheld would be due on the unextended due date of the return. No penalty for underpayment of estimated tax would be imposed as long one of the following amounts was paid by the unextended due date of the return: (a) 90% of the withholding tax due for the current taxable year; or (b) 100% of the withholding tax due for the prior taxable year if that taxable year was a period of 12 months and the entity paid withholding tax as required under these provisions. However, interest at 12% would apply to the unpaid amount of tax withheld during any extension period and interest at the rate of 18% would apply to the unpaid amount of tax withheld for the period beginning with the extended due date and ending with the date of full payment of the withheld tax.

As under current law with respect to persons required to withhold income tax, any tax withheld under these provisions would be held in trust for the state, and the pass-through entity would be liable to DOR for payment of the tax withheld. No partner, member, shareholder, or beneficiary of a pass-through entity would have any right of action against the pass-through entity with respect to any amount withheld and paid in compliance with these provisions. In addition, if a pass-through entity failed to withhold tax as required under these provisions, the entity would be liable for any tax, interest, and penalties. If a nonresident partner, member, shareholder, or beneficiary of a pass-through entity filed a return and paid the tax due, the pass-

through entity would not be liable for the tax but would be liable for any interest and penalties otherwise applicable to failure to withhold under general income and franchise tax provisions.

The pass-through entity would be required to annually notify each nonresident of the amount withheld on or before the extended due date of the pass-through entity's return and furnish a copy of the notice to the Department of Revenue (DOR). The person could claim a credit for the amount withheld on the person's state income or franchise tax return.

The administration estimates that these provisions would increase state income and franchise tax revenues by $7,500,000 in 2005-06, and $5,000,000 in 2006-07.

DISCUSSION POINTS

1. Until relatively recently, the C corporation was the most common form of organization for a business that did not operate as a partnership or sole-proprietorship. A C corporation is subject to tax on business income at the level of the business entity. Stockholders are only taxed on corporate profits if such profits are distributed, at which point they become part of a stockholder's income.

2. In the past decade, the number of business entities in Wisconsin organized as pass-through entities has increased significantly. As described above, and in contrast to the income tax treatment of C corporations, income of pass-through entities is not subject to tax at the level of the business entity but is "passed through" to be taxed to the members or shareholders. According to information from the Department of Financial Institutions (DFI) and DOR, between December 31, 1996, and December 31, 2004, business entities formed as tax-option corporations, limited partnerships, LLCs, and limited liability partnerships have increased in number by approximately 265%. During the same time period, the number of C corporations increased approximately 16%.

3. The growth rate of the business entities other than C corporations described above does not exactly reflect the growth rate of pass-through entities, as it includes some business entities that do not pass income through (LLCs treated as sole-proprietors or corporations for federal tax purposes) and excludes others that do pass income through (general partnerships, for which detailed data is not available). However, the figure does serve as a reasonable proxy for the growth rate of pass-through business entities. At the end of 2004, there were approximately three times as many of such business entities as there were C corporations. The faster rate of growth of new business entities organized in a form other than a C corporation, compared to growth rate of new C corporations, is expected to continue, including such entities that pass income through to members or shareholders.

4. Based on sampling and the experience of other states, DOR believes that many pass-through entities with Wisconsin income have nonresidents as partners, members, or shareholders. If a shareholder of a tax-option corporation does not file a Wisconsin return and pay the Wisconsin income tax on the shareholder's share of the corporation's Wisconsin income, the corporation may be taxed on the income. However, according to DOR, the four-year statute of limitations for both

the tax-option corporation and a nonresident shareholder may expire before the Department determines that the tax has not been paid. With respect to limited liability companies and partnerships, there is no requirement for the business entity to pay tax on a nonresident partner's or member's income on which Wisconsin tax has not been paid.

5. The Internal Revenue Service recently released preliminary results of a major research project assessing compliance with individual income tax laws, and concluded that most of the understated income comes from business activities. State tax officials have long recognized a particular challenge in enforcing individual income tax laws with respect to nonresident members and shareholders of pass-through entities. In 1991, the Multistate Tax Commission recommended to states a Model S Corporation Income Tax Act that included language requiring tax option corporations to either withhold income tax on behalf of nonresident shareholders or to file agreements under which nonresident shareholders consent to file returns and pay taxes. On December 18, 2003, the Multistate Tax Commission recommended similar language with respect to other pass-through entities as well. In each case, the recommendations of the Multistate Tax Commission included language that would allow for the filing of composite income tax returns on behalf of nonresident members.

6. Approximately 30 states have adopted withholding provisions for some or all nonresident owners, members, or partners. A few states have withholding requirements for either tax-option corporations or other types of pass-through entities (partnerships and LLCs taxed as partnerships) but not both tax-option corporations and other types of pass-through entities. Many states require withholding only in the case of nonresident owners, members, or partners that do not file consent to pay tax or participate in a composite income tax return.

7. Under the bill, with the exceptions described under the Governor's proposal, the requirement to withhold taxes would apply to all pass-through entities with respect to income attributable to Wisconsin of nonresident partners, members, shareholders, or beneficiaries. There would be no exception for such persons filing composite returns or consent to file agreements. The bill would not prohibit composite returns, but the withholding requirement would still apply and the taxes withheld on behalf of nonresident filers would then be subtracted from taxes payable with the return (as is generally the case with taxes that have been withheld from income). With respect to consent to file agreements, DOR indicates that such agreements are not a guarantee that taxes will be paid and, in the absence of the proposed withholding requirements, would still require significant enforcement efforts. For this reason, the Department is in favor of requiring withholding even for nonresident filers with consent to file agreements.

8. The proposed withholding requirements would first apply to tax years starting on or after January 1, 2005. The administration estimates that, under the provisions, tax revenues would increase by $7.5 million in 2005-06 and in $5.0 million in 2006-07. The estimate for the first year is higher than that for the second year under the assumption that, in the first year, additional tax payments would be received from prior year amended returns of nonresidents associated with Wisconsin income from pass-through entities on which Wisconsin taxes had not been paid.

9. The administration's estimates of the fiscal effect of the proposal are based, in part, on a review by Deloitte Consulting conducted at the end of 2003 and in the early part of 2004. At that time, Deloitte Consulting presented a number of suggestions to the administration on potential cost reductions and enhanced tax compliance initiatives that could benefit the general fund. One of these suggestions was to institute withholding requirements for non-resident members, partners, and shareholders of pass-through entities. Deloitte Consulting also suggested the establishment of a support database toolset to facilitate nonfiler automated detection and underreporting. Based on a review of the experience of other states that have implemented such withholding requirements and have also implemented a support database such as the one recommended by the consulting firm, Deloitte Consulting estimated revenues of $10 to $20 million would be received on a one-time basis and ongoing, annual receipts of $2 to $5 million.

10. The state of Minnesota received approximately $22 million in fiscal year 2003-04 from withholding for nonresident partners and members of tax-option corporations for calendar year 2004. The state of Michigan, which adopted similar withholding provisions effective October 1, 2003, estimated annual revenues of $2 million from the provisions at the time the withholding requirement was adopted. (Michigan has not yet analyzed actual tax receipts resulting from the withholding requirement). Neither state has implemented an extra support database specifically to enhance collection of withholding associated with nonresidents and income from resident pass-through entities.

11. It should be noted that the tax on Wisconsin income of nonresidents partners, members, and tax-option corporation shareholders is already imposed under current law. AB 100 is intended to increase compliance with current law. The imposition of a withholding requirement for pass-through entities and nonresidents would be consistent with similar requirements for nonresidents employed in Wisconsin and nonresident lottery winners.

12. In the absence of data specific to Wisconsin, it is not possible to predict revenues from the proposed withholding requirements with precision. However, based on the Deloitte Consulting review and the experience of two of Wisconsin's neighboring states that have enacted similar provisions, the estimates included in AB 100 of $7.5 million in 2005-06 and $5.0 million in 2006-07 appear to be reasonable.

13. Currently, the withholding requirements for nonresident partners provided under the bill would apply to publicly traded partnerships (PTPs) treated as partnerships. (PTPs that are taxed as corporations at the federal level would not be required to withhold taxes under the bill). The Department has requested an amendment that would allow an exception from the nonresident withholding requirements for PTPs treated as partnerships under certain circumstances. The following section describes PTPs and the proposed modification.

14. A PTP is a partnership, the interests of which are "units" that are traded on public stock exchanges. According to DOR, if PTPs derive 90% of their income from qualified sources, they are treated as partnerships under federal tax law. All other PTPs are taxed as corporations. Income from qualified sources includes mineral or natural resources activities such as exploration,

production, mining, refining, marketing, and transportation of oil and gas, minerals geothermal energy, timber, and real property. There are currently 10 PTPs treated as partnerships that operate in Wisconsin.

15. DOR reports that PTPs may have thousands of unitholders, and that such unitholders receive regular distributions, a portion of which is often a nontaxable return of capital. A unitholder's share of the PTP's taxable income may be very small, and the proposed withholding requirement could prove to be a large burden.

16. The recommendation of the Multistate Tax Commission with respect to withholding requirements for nonresident members of pass-through entities exempts PTPs treated as partnerships from such requirements if certain requirements are met, as do some states that have adopted withholding requirements for nonresident partners of partnerships with Wisconsin income. While data is not available to estimate the fiscal effect of exempting PTPs from the withholding requirement, DOR expects that the effect would be minimal. DOR has requested that the bill be modified to specify that a PTP treated as a partnership under the Internal Revenue Code would not be subject to the withholding requirements if the entity agreed to file an annual information return reporting the name, address, taxpayer identification number, and other information requested by DOR for each unitholder with an income in the state from the PTP in excess of $500. These provisions are the same as those recommended by the Multistate Tax Commission with respect to PTPs.

ALTERNATIVES

1. Approve the Governor's proposal.

2. Approve the Governor's proposal with a modification that would exempt PTPs treated as partnerships from the withholding requirements under the bill if the entity agreed to file an annual information return reporting the name, address, taxpayer identification number, and other information requested by DOR for each unitholder with an income in the state from the PTP in excess of $500. Under this alternative, there would be no change from the estimated fiscal effects under the bill.

3. Maintain current law. Reduce general fund revenues by $7.5 million in 2005-06 and by $5.0 million in 2006-07.

Alternative 3	GPR-REV
2005-07 REVENUE (Change to Bill)	**-** $12,500,000

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