Legislative Fiscal Bureau

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May 27, 2009 Joint Committee on Finance Paper #359

Withholding Payments for Pass-Through Entities (General Fund Taxes -- Income and Franchise Taxes)

[LFB 2009-11 Budget Summary: Page 257, #6]

CURRENT LAW

As provided under 2005 Wisconsin Act 25, pass-through entities [including partnerships, limited liability companies (LLCs), tax-option corporations (S Corporations), and estates or trusts treated as pass-through entities for federal income tax purposes] are generally required to withhold income or franchise tax on behalf of their nonresident shareholders, partners, members, or beneficiaries (referred to below as "nonresidents"). However, withholding is not required if the nonresident is exempt from income taxation or is a joint venture not treated as a partnership under federal law. An exemption is provided for a nonresident who presents an affidavit, in the form and manner prescribed by the Department of Revenue (DOR), whereby the nonresident agrees to be subject to the personal jurisdiction of the Department, the Tax Appeals Commission, and the courts of Wisconsin for the purpose of determining and collecting Wisconsin income and franchise taxes, estimated payments, and any related interest and penalties. Pass-through entities must make an annual withholding payment by the unextended due date of the entity's income or franchise tax return.

GOVERNOR

Modify the current law withholding requirement for pass-through entities so that they would be required to make estimated withholding tax payments for non-resident individuals on a quarterly basis, rather than annually, effective with taxable years beginning on January 1, 2009. Repeal the current law provision relating to withholding tax payments for nonresidents by pass-through entities that requires the entity to make annual payments of withheld tax, and, instead, require pass-through entities to file an annual return, on the same dates that payments are currently required, reporting the entity's withholding tax payments during the entity's taxable year. Additional details related to this recommendation are included as an attachment to this paper.

The administration estimates that the provision would increase income tax collections by $38,500,000 on a one-time basis in 2009-10.

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. In the past decade, the number of businesses in Wisconsin organized as pass-through entities has increased significantly. 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.

2. Wisconsin income allocable to nonresident shareholders, partners, members, or beneficiaries of pass-through entities is subject to Wisconsin's individual income tax. Pass-through entities are partnerships, LLCs, tax-option corporations, estates, and trusts that are treated as pass-through entities for federal tax purposes. Pass-through entities are generally required to pay withholding tax on Wisconsin income allocable to their nonresident shareholders, partners, members, or beneficiaries in a single payment. The payment is due by the unextended due date of the pass-through entity's income or franchise tax return. The AB 75 proposal would require quarterly, rather than annual, withholding tax payments by pass-through entities for non-residents.

3. For nonwage income not subject to withholding, Wisconsin residents are required to make quarterly estimated tax payments. Residents who wait to pay taxes on this income until they file their tax return may be assessed underpayment interest. By requiring a single annual payment for nonresidents and quarterly payments for residents, nonresidents are treated more favorably than residents.

4. The state's current pass-through withholding requirement first applied to tax years beginning after January 1, 2005. Since then, pass-through withholding payments have grown from $25 million in 2005-06, to $72 million in 2006-07, and $77 million in 2007-08. Through April, 2009, pass-through withholding for 2008-09 totals $64 million. At year's end, pass-through withholding amounts are allocated to the individual income tax and to the corporate income and franchise tax, and reflected in the totals for those taxes.

5. Based on information supplied by the Department of Revenue, 31 states, including Wisconsin, impose withholding requirements on pass-through entities. Among those states, 15 states require withholding by the same types of entities as Wisconsin, and 15 states require withholding by fewer types of entities.

6. The proposal is estimated to increase income tax collections by $38.5 million on a one-time basis in 2009-10. Over 75% of all pass-through payments occur in March or April, which are three or four months, respectively, after December 31. Therefore, one can assume that most pass-through entities are organized on a calendar year basis. Under the proposal, pass-through entities would be required to make payments in the third, sixth, ninth, and 12th months of their tax year. For entities organized on a calendar year basis, one annual payment, which is now made in March or April of one year, would be replaced with four quarterly installments made in March, June, September, and December of the preceding year. The latter two payments (September /December) would occur in the same state fiscal year as the annual payment required under current law, but the former two payments (March/June) would occur in the state fiscal year that precedes the fiscal year of the annual payment.

ALTERNATIVES

1. Approve the Governor's recommendation.

2. Delete provision.

ALT 2	**Change to Bill** Revenue
GPR	**-** $38,500,000

Prepared by: Rick Olin
Attachment

ATTACHMENT

Technical Description of Pass-Through Withholding Proposal

Modify the current law withholding requirement for pass-through entities so that they would be required to make estimated withholding tax payments for non-resident individuals on a quarterly basis, rather than annually, effective with taxable years beginning on January 1, 2009. Repeal the current law provision relating to withholding tax payments for nonresidents by pass-through entities that requires the entity to make annual payments of withheld tax, and, instead, require pass-through entities to file an annual return, on the same dates that payments are currently required, reporting the entity's withholding tax payments during the entity's taxable year. Require DOR to allow an automatic extension for the annual return of seven months or until the due date of the entity's federal income tax return or return of partnership income, whichever is later, and impose interest at a rate of 12% annually on any payment covered by the extension. Subject entities that do not file an annual report by the extended due date to the civil penalty for taxpayer negligence authorized under current law, in addition to their liability for any unpaid tax, interest, and penalty otherwise assessable. Extend delinquent interest to any amounts where 90% of the withholding tax reported on the entity's annual return is unpaid by the unextended due date. Repeal the related provisions under current law.

Require pass-through entities to make estimated payments of withheld taxes in four installments on, or before, the 15th day of the third, sixth, ninth, and twelfth months of the taxable year. Establish a payment for each quarter equal to 25% of the lesser of 90% of the withholding tax due in the current year or 100% of the withholding tax due in the preceding year, unless the preceding tax year was less than 12 months or the entity did not file a return in the preceding year. As an alternative, authorize entities to calculate their payments based on their annualized income at the following percentages: (a) 22.5% for the first installment; (b) 45.0% for the second installment; (c) 67.5% for the third installment; and (d) 90.0% for the fourth installment. Under this alternative calculation, "annualized income" would mean the entity's income for the months in the taxable year ending before the installment's due date, annualized under methods prescribed by DOR. In addition, authorize an entity using the annualized income payment alternative to use the apportionment percentage from its prior year tax return, provided the tax return was filed before the due date for the installment for which the income is being annualized and the percentage is greater than zero. Require any entity using the annualized income payment alternative to increase the next installment computed under the standard (25%) payment procedure by the difference between the amount paid under the alternative procedure and the amount that would have been paid under the standard procedure.

Assess interest at the annual rate of 12% on any underpayment of estimated withholding tax for the period of the underpayment. Define "period of the underpayment" as the time period between the installment's due date and the earlier of the unextended due date for the pass-through entity's annual return or the date for the installment payment. Waive interest payments on underpayments if the amount of withholding tax due is under $500 or if the amount of withholding tax due is less than $5,000, the pass-through entity had no withholding tax liability for the preceding taxable year, and the preceding taxable year was 12 months. Repeal the current law requirement that: (a) makes the pass-through entity liable for any unpaid tax, interest, and penalty; and (b) waives the pass-through entity's liability for the tax, but makes the pass-through entity liable for any interest and penalty payments on any unpaid withholding tax, if the nonresident taxpayer files a return and pays the tax.

Extend current law income and franchise tax provisions related to refunds, the carry-forward of refunds, prepayments, short-years, overpayments, and exceptions to final installments to the withholding tax for pass-through entities.

For payments due between January 1, 2009, and the bill's effective date, require DOR to consider withholding payments that become due as timely if the payments are made by the installment date following the bill's effective date unless the installment due date is less than 45 days after the bill's effective date. Provide that if that installment date is less than 45 days after the bill's effective date, withholding payments would be considered timely if received by the succeeding installment due date.