Partnership Withholding: When is it Required?

Rules, guidelines and exceptions

Partnerships must withhold income taxes when distributing current or prior year income to domestic nonresident partners (R&TC Secs. 18662 and 18666). For those of you who read the instructions to Form 565, **California Partnership Return of Income**, this is old news. For the rest of us, let's review the rules for domestic and foreign nonresident partner withholding.

The rules are different for domestic nonresident partners and foreign partners. For nonresident domestic partners, the partnership must withhold if it distributes more than $1,500 of California-source distributable income, not return of capital. The withholding rate is 7 percent.

For non-U.S. resident (foreign) partners, the partnership must withhold based on the partner's California-source taxable income, whether or not it is distributed. The withholding rate is the maximum California tax rate for the taxable year. Withholding is required if federal withholding is required under IRC Sec. 1446 and the partnership has California-source income. (R&TC Sec. 18666)

Notice required

For domestic nonresidents, withholding is required once the FTB notifies the partnership and a partner's distributions for the year exceed $1,500 unless a waiver is obtained from the FTB. Withholding is required based on a current year distribution of prior years' income reported after December 31, 1992. Withholding can be avoided if the partnership receives a signed statement (FTB Form 590-P) certifying that the prior year's income was previously reported.

The FTB sends approximately 22,000 letters annually to all new partnerships on file. The letter is a tool used by the FTB to make the newly formed partnership aware of the requirement to withhold on distributions to its domestic nonresident partners or the requirement to withhold on allocation to its foreign partners.

Domestic nonresident partners subject to the withholding include individuals, trusts, estates, grantor trusts, partnerships and corporations. Those who are resident partners or estates of California decedents may file Form 590, **Withholding Exemption Certificate**, to certify themselves from the withholding.

Exceptions to withholding

Withholding is not required if any of the following apply:

- The partner is a resident of California.
- The partner is a corporation qualified to do business in California or has a permanent place of business in California.
- The partner is a partnership that has a permanent place of business in California.
- Total distributions of California source income for the year to the partner are $1,500 or less for the calendar year.
- The partner receives a withholding waiver from the FTB.
- The partner is a tax-exempt entity either under California or federal law.
- The distribution is of tax-exempt income.
- The distribution is of California source income that was reported on the partner's previous California return.
- The partnership does not have any California source income.
- The partnership is an investment partnership.

To be an investment partnership, generally 90 percent of the partnership's assets and gross income must be from qualifying investment securities or bank deposits (interest, dividends and gains from sales of the securities). A partnership interest in another partnership does not qualify unless it is also an investment partnership.

$1,500 threshold

If the partnership expects that the total calendar year distributions will exceed $1,500, it must withhold on the entire California source income that is distributed, not just the amounts exceeding the $1,500. If, however, it did not "reasonably expect" the distributions to exceed $1,500, then there is no requirement for the partnership to "catch up." This calculation is made per partnership. Thus, if a nonresident is invested in several partnerships, they are all treated separately.

If property, rather than money, is distributed, the property's fair market value (not adjusted basis) is used to determine the amount of the withholding.

Sources within and without California

If the partnership has income both from within California and from without California, it must determine the portion that is California source and withhold on that amount, if the California source income exceeds the $1,500 threshold. Any reasonable method of allocation may be used, such as using the prior year's ratio or apportionment factor, annualizing current year data, etc. This assumes a good faith effort is made by the partnership. Guaranteed payments to partners must also be allocated.

If income generated in prior years has not been previously distributed, current year distributions are first considered as a distribution of prior years' income. Any remaining amount is treated as a distribution of current year income.

Required withholding forms

If the partnership is required to withhold, it must file separately for each year (even if the distributions are all made in the same year (see above)):

- Form 592, **Nonresident Withholding Annual Return**;
- Form 592-A, **Nonresident Withholding Remittance Statement**; and
- Form 592-B, **Nonresident Withholding Tax Statement.** Copies B and C are sent to the partner.

The partnership cannot use Form K-1 to report these amounts (but it might be a good idea to note that amounts have been withheld on either Schedule K-1 or on the letter to the partner so that the accountant is aware of the withholding).

These returns are generally due on or before January 31 following the close of the calendar year.

If distributions for the prior year are made on or before January 31 of the following year, they can be included on the prior year's report, even though made after the year-end.

Due date of the withholding

Withholding is due the twentieth day of the month following the date of the distribution if the total amount withheld from all payees exceeds $2,500

Example of Domestic and Foreign Nonresident Partners

ABC is a California partnership that operates a restaurant within California. Bernie and Lars are two partners in the company. Bernie is a domestic nonresident whose distributive share of the profit or loss is 20 percent. Lars is a foreign nonresident whose distributive share of the profit or loss is also 20 percent. ABC has an income of $100,000 for 2001, and distributes $5,000 of ordinary income to each partner on December 31, 2001.

The calculations for the nonresident withholding are as follows:

Domestic nonresident withholding	
Distributions	$5,000
Withholding rate for domestic nonresident partners	x 7%
Bernie's domestic nonresident withholding	$350
Foreign nonresident withholding	
Income	$100,000
Partner's share of income	x 20%
California maximum tax rate for 2001	x 9.3%
Lars' foreign nonresident withholding	$1,860

for the calendar year. If the total does not exceed $2,500, then the withholding is due by January 31 of the following year.

Interest and penalties

If the withholding is not paid on time, interest is charged on the unpaid amount until the tax is paid. If a partnership fails to withhold or pay over the withholding, the penalty is the greater of:

- The amount actually withheld (but not paid to the FTB); or
- The amount of the taxes due from the partners, but not more than the amount required to be withheld.

Generally, the FTB will "work with partnerships to establish withholding procedures and to resolve instances of failure to withhold before assessing penalties." Penalties will be withdrawn if the partnership shows that the failure was due to reasonable cause.

Tiered partnerships

If a partnership has invested in another partnership and that partnership withholds, the partnership that withholds must complete Form 592 as if it had withheld that amount so that it can pass the withholding credits onto its partners.

FTB waivers

Waivers are handled by the FTB on a case-by-case basis by filing Form 588, **Nonresident Withholding Waiver Request**. Either the partner or the partnership can file Form 588. The FTB generally grants a waiver if any one of the following applies:

- The partner consistently files California returns and makes estimated tax payments.
- The partner is a partnership that will withhold on its distributions.
- The partner is included in a group return (individuals who are nonresidents may elect under R&TC Section 18535 to file a group return).
- The partner is a newly admitted partner (admitted after the end of the tax year).
- The partnership is a publicly traded partnership.
- The partner can demonstrate that the 7-percent rate will result in over withholding.
- The partnership is encountering administrative problems setting up the withholding program.

Send Form 588 to:

Partnership Waivers/Withholding-At-Source Unit
Franchise Tax Board
P.O. Box 651
Sacramento, CA 95812-0651

Or for more information call:

(916) 845-4900

Prior year net operating losses do not effect current year withholding requirements. However, a partner that has net operating loss carryovers in the current year can ask the FTB for a withholding waiver.

How to determine residency

Two methods are permitted. Either have the partner complete Form 590 or the partnership may rely on a California street address as an indication of the partner's residency status. A valid California street address however, does not include a California post office box, a broker's address or an "in care of" address.

The term resident includes every individual who is in California for other than a temporary or transitory period. Long or indefinite stays may also constitute residency. For more information, see FTB Publication 1031.

Non-U.S. partners

The rules relating to foreign nonresident, non-U.S. partners are slightly different. California generally conforms to IRC Sec. 1446 (R&TC Sec. 18666), which requires partnerships to withhold on amounts subject to IRC Sec. 1446 withholding based on the California source income (effectively connected to the California trade or business).

For U.S. residents, the difference from the above requirements is that this requirement is based on income, not the distributions of that income.

Payments of this withholding tax are due in four equal installments during the taxable year in which the California income is derived. The due dates are the same as the federal: the fifteenth day of the fourth, sixth, ninth, and twelfth months of the partnership's year.

The withholding taxes are paid with the same forms and on the same dates as used for withholding from domestic nonresident partners as listed above. Interest and penalties are the same as discussed above.

Because the federal and California laws are almost the same, some useful guidance can be found in the following:

- FTB Pub. 1017, **Nonresident Withholding Partnership Guidelines.**
- IRS Pub. 541, **Tax Information on Partnerships**
- IRS Pub. 519, U.S. Tax Guide for Aliens
- IRS Pub. 515, **Withholding of Tax on Nonresident Aliens and Foreign Corporations**

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Important Tax Rulings

Occupational license information invalid — The Board of Equalization recently rejected the FTB's practice of using occupational license information to create assessments for a nonfiler who failed to respond to notices demanding that the taxpayer file California income tax returns (***Appeal of Lenora Koopmeiners***, June 21, 2001*).

In this case, the FTB based an assessment on the taxpayer's $12,146 of income from a job at Wal-Mart, plus $45,739 in income the FTB assumed the taxpayer earned because she held a pharmacy technician's license. Since 1993, the FTB has used occupational license information to create assessments against non-filers who fail to respond to request and demand notices. The FTB sends proposed assessment to holders of occupational licenses who do not file a return or explain to the FTB why a return is not required.

The NPA assumes that these taxpayers:

- Are self employed;
- Have gross profit from their presumed self employment equal to the "industry average" for that particular industry; and
- Have net income that is the same as their gross profit.

The program originally encountered some problems, and was refined to create assessments that the FTB felt would more accurately reflect the income the taxpayer may have had. However, in ***Koopmeiners***, the Board held that the FTB provided no explanation of "...why attributing such income to [the taxpayer] is a rational method of reconstructing income allegedly received ... in her occupation as a licensed pharmacy technician."

The Board reversed the proposed assessment with regard to the FTB's reconstruction of the taxpayer's income, stating that the FTB had not taken into consideration the fact that the taxpayer's wages from Wal-Mart may have been compensation for work as a licensed pharmacy technician. Based on this decision, it seems that where a taxpayer has reported some wages the FTB will have to present a reasonable basis for reconstructing income based on an occupational license.

Per capita income not taxable to nonresident — Income from Indian gaming is not taxable to a nonresident (***Appeal of Samuel L. Flores***, 2001-SBE-004).

In the recent appeal, the FTB argued that the tribal income from the Morongo Band of Mission Indians should be treated as partnership income, taxable to California because it is a California-based band. However, in a formal opinion that reverses its earlier position, the Board ruled that income from Indian gaming is treated "...as an association taxable as a corporation," and the income has its source in the taxpayer's state of residence.

Besides being an enrolled member of the Morongo Indians, the taxpayer was also a resident of Washington who received per capita payments from the tribe. Although the payments are taxable for federal purposes, the taxpayer is not taxed by California because the payments are treated like dividends, taxable only to California residents.